PERESTROIKA AND ITS IMPLICATIONS FOR THE UNITED STATES

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HOUSE OF REPRESENTATIVES

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PERESTROIKA AND ITS IMPLICATIONS FOR THE UNITED STATES

FRIDAY, SEPTEMBER 23, 1988

U.S. House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:37 a.m., room 2359-A, Rayburn House Office Building, Washington, DC, Hon. John J. LaFalce (chairman of the committee) presiding.

Present: Chairman LaFalce; Representatives Bilbray, Flake, Lancaster, Campbell, Martinez, and Slaughter.

Chairman LaFalce. The Small Business Committee will come to order.

Today marks the beginning of the series of hearings on the economic relationship between the United States and the Soviet Union with a particular emphasis on long-term trade prospects for American small business. This hearing will focus on *perestroika* and its implications for the United States.

In my opinion, *perestroika*, economic restructuring, represents a fundamental recognition by the Soviets that they must begin to develop a more market-oriented economy in order to revitalize their economic system and become internationally competitive. However, before we can assess whether *perestroika* would result in any significant long-term opportunities for increased trade by American small business, which we will examine in greater depth next Friday, we must examine the background and current state of our overall trade relationship with the Soviet Union, as well as the significance of its internal reforms.

Trade with the Soviet Union has traditionally been viewed within the context of our overall relationship: In terms of East-West competition; responses to regional problems; and domestic politics. As a result, our volume of trade with the Soviets has historically been small and our trade policy toward them has been characterized by lightswitch diplomacy. For example, even at its peak in 1979, when total trade between our two countries reached $4.5 billion, this represented only about 1 percent of United States trade. Last year, trade between the two countries was $2 billion.

At last December's summit, President Reagan and General Secretary Gorbachev urged the development of concrete proposals for the expansion of U.S.-Soviet trade. This led to the signing of a Joint Statement, at the conclusion of the April meeting of the Joint U.S.-U.S.S.R. Commercial Commission, in which both countries strongly support expansion of mutually beneficial commercial relations which they believe can contribute to the development of a more constructive relationship between the two countries.

There are many different foreign economic policy approaches that the United States could take now with regard to the Soviet Union. For example, we could follow a passive policy to expand trade. And this means that we would simply wait until there is even greater progress on the four major Summit Agenda items: Arms control; regional conflicts; human rights; and bilateral issues; and then respond with new trade and economic policies toward the Soviet Union.

However, one problem with this approach is that the United States is already losing market share in the Soviet Union to the Europeans and Japanese, who continued to expand trade there during 1980 to 1986, when the United States did not even conduct a trade fair in that country.

Alternatively, we could adopt a more active policy, an active policy perhaps based on certain conditions that the Soviets must meet, in order to enhance trade and economic relations between our two countries.

Most importantly, the United States must carefully reevaluate its foreign economic policy, and particularly its trade policy, toward the Soviet Union. Next to our mutual interest in avoiding war, economic relations may hold the greatest opportunities for increased American-Soviet cooperation.

The purpose of this hearing is to examine these questions and the implications of *perestroika* for the United States in terms of the prospects for such increased trade and economic cooperation. In particular, we will focus on the following issues: The significance of the ongoing and proposed Soviet reforms for American foreign-economic policy and American business; current U.S. economic and trade policies toward the Soviet Union in light of these reforms; any costs and benefits of increased economic and trade relations for both countries; and the extent to which increased trade relations might contribute to the continuation of improved overall relations with the Soviet Union; and Soviet market prospects and potential for American business.

We are pleased to have the following distinguished individuals with us this morning who can speak with much authority on these issues. First we will hear from Louis Laun, Assistant Secretary for Economic Affairs of the International Trade Administration; and Dr. Susanne Lotarski, Director of the Office of Eastern Europe and Soviet Affairs within the Department of Commerce. Then we shall hear from a panel consisting of Dr. Marshall Goldman, Russian Research Center, Harvard University; and Mr. Eugene Milosh, president of the American Association of Exporters and Importers, and former vice president of the U.S.-U.S.S.R. Trade and Economic Policy.

[Chairman LaFalce's opening statement may be found in the appendix.]

Chairman **LaFalce**. Do any members of the panel have any statements they wish to make?

Mr. Bilbray.

Mr. **Bilbray**. Yes, Mr. Chairman.

It is with great pride that I take part in this hearing on the economic relations between the United States and the Soviet Union with regard to small business.

The Committee on Small Business has been concerned with all issues that affect our Nation's small businesses, and because of today's hearing we will see the possibilities of the ramification of the international involvement of the Soviet Union in American small businesses.

I cannot emphasize enough the positive influence of involving international players in the small business community. We are looking to have the international market take over the small businesses. We seek to have them become an integral part of our businesses.

During August 1987, as a member of the Foreign Affairs Committee on Trade, I had the honor to represent the United States for the opening of the Cultural Exhibit in Kiev and the Ukraine of the U.S.S.R.

I found that various Russian and Ukrainian leaders could talk of little except increased trade in joint ventures with the United States.

I think the opportunity is here and our businessmen should take cautious advantage of this opportunity.

Thank you.

Chairman LAFALCE. Thank you very much.

Now we are pleased to have two longtime friends, Louis Laun, who when I first came to Congress was Deputy Administrator of the SBA, and Dr. Susanne Lotarski, who I know from our days together in Buffalo, NY.

Mr. Laun.

TESTIMONY LOUIS F. LAUN, ASSISTANT SECRETARY OF COMMERCE FOR INTERNATIONAL ECONOMIC POLICY, DEPARTMENT OF COMMERCE, ACCOMPANIED BY DR. SUSANNE LOTARSKI, DIRECTOR, OFFICE OF EASTERN EUROPE AND SOVIET AFFAIRS

Mr. LAUN. Thank you very much, Mr. Chairman. I have a relatively short statement, and I will make that a little bit shorter and summarize it.

Chairman LAFALCE. Fine.

Mr. LAUN. I'm very happy to be here this morning to discuss changes that are taking place in the Soviet economy and their implications for U.S. international economic policy.

It is also a pleasure for me to appear again before this committee. It has been some time. I know from my experience in SBA that this committee has a very useful role to play in advancing U.S. economic interests, and particularly the vibrant small business sector.

Significant economic changes, what the Soviets have called *perestroika*, or restructuring, are being initiated in the Soviet Union, in part I really believe, because their system has too long ignored small business. In the late 1920's the Soviet Union glorified gigantic undertakings, huge mills and factories.

Small businesses, along with private enterprise, were virtually eliminated from this system. Political decisions by a few at the center were substituted for economic decisions and competition of the many.

We know that much vitality and innovation are provided by small- and medium-size firms. A mix of different sized enterprises, independent, competing with each other, is better than any other system in stimulating innovation and growth.

Seventy years after the Bolshevik Revolution, the Communist Party's Central Committee concluded, and I quote: "The centrally planned command administrative system of managing the economy has become a serious brake and has put the Soviet Union on the brink of an economic crisis."

The remedies under *perestroika* are aimed at easing the grip of central planners and increasing the scope of decisionmaking by enterprises. Output produced in accordance with mandatory state orders is to decline and be replaced by a wholesale trade system.

State enterprises are to assume more responsibility for their costs and revenues. State subsidies are to be cut. Prices are to become more responsive to supply and demand.

Even their creation of small businesses is being encouraged, although so far only as cooperatives.

Foreign trade is also undergoing *perestroika*. For decades, the U.S.S.R. pursued a policy of self-sufficiency. Their economy has been protected. Foreign trade with the West accounts for less than 2 percent of Soviet GNP.

Until recently, Soviet foreign trade has been centrally planned. Foreign trade transactions have been a monopoly of the Ministry of Foreign Trade.

Until recently, the Soviets have sharply limited cooperation with Western firms. There was no Western company ownership of the means of production, no participation in management, and little in marketing.

They bought turnkey plants. By the time they went into operation they often were using decades-old equipment and processes to produce decades-old products.

Often Soviet manufacturers didn't get exactly what they needed because they were working through middlemen such as the National Soviet Foreign Trade Organizations.

Two years ago they began reforming their foreign trade system. There are two major features. The first breaks the Foreign Trade Ministry's monopoly. More than 100 Soviet ministries and enterprises have been authorized to deal directly with foreign countries, including the right to sign contracts and retain a portion of hard currency earned through exporting.

The second measure authorizes new forms of cooperation, including joint ventures, with foreign firms.

Three hundred joint ventures are being discussed with Western companies. Only about 60 or so have been formed to date. They tend to be small, because Soviet joint venture policies are very difficult, particularly a Soviet requirement that joint ventures must export to the West.

Most Western companies interested in joint ventures want to sell in the Soviet market, not create a Soviet manufacturing base to supply Western markets that they already are adequately covering.

According to the Soviets, Western companies have invested to date only about $30 million in capital in all these joint ventures. Many ventures are to be implemented in stages, phased in over a number of years; this is a slow process.

Joint ventures are not likely to play a major role in Soviet foreign economic relations for some time. But they represent a significant step by the Soviets to open up to the West and to become more integrated in the world economy.

These trade reforms are far-reaching. Like broader economic reforms, they are just beginning. Implementation will take time.

The success of *perestroika* depends on the Soviets. The West's ability to influence the success or failure is limited. The West did not create the problems of the East, and would not be able to solve them. Improvement in the Soviet economy can only come from genuine and far-reaching changes in the Soviet economic system itself.

I believe the trade policy the Reagan administration has put in place enables us to deal with the changes occurring in the U.S.S.R. and to take advantage of the commercial opportunities.

I guess where I have come down, Mr. Chairman, on your comments as to whether we should adopt a more active policy or an active policy based on certain conditions which the Soviets must live up to, is that the latter is the Reagan administration trade policy. I don't think we need to reevaluate it because I think we're doing exactly that.

Our policy is based on the view also that security and political interests, including our concern for human rights, dominate the bilateral relationship, and that economic cooperation cannot be viewed separately from the total relationship.

Strategic goods and technology are not areas where we are interested in trade expansion. Our own and multilateral controls on the export of militarily useful goods and technology must be vigilantly maintained.

Second, the administration is firm in its support of the Jackson-Vanik Amendment to the Trade Act of 1974, relating Most Favored Nation tariff treatment to freedom of emigration. Without sustained and substantial emigration there will be no MFN treatment for Soviet products in the U.S. market.

Export credit and credit guarantee programs are governed by the same Jackson-Vanik criteria as MFN. We don't extend Government export credit programs to the U.S.S.R. In addition, we adhere to the 1983 Williamsburg Summit principle that Western governments should not provide subsidized export credits to the East. Exports should take place on commercial terms.

With regard to joint ventures, President Reagan and General Secretary Gorbachev agreed at the 1987 Washington Summit that joint ventures, as you said, ought to play a role in the development of commercial relations.

U.S. laws and policies are in place to handle any transfer of technology involved. Any proprietary technical data transferred to the U.S.S.R. through joint ventures must have an export license.

Within this framework, our policy is to seek step-by-step improvements in trade where possible, strictly in non-strategic areas. Since resuming bilateral trade in 1985 we have attempted to gain market access and market information. In 1985 the Soviets agreed to make bid information available to American companies and consider their proposals on economic grounds.

In April of this year, the Soviets agreed to allow access for Soviet business people to the U.S. Commercial Office in Moscow. That may not sound like such a big deal, but before that they had armed guards standing out in front of our offices in Moscow and the Soviets couldn't get into the office. They are now stopping that. They have also allowed distribution of a U.S. commercial newsletter to Soviet businesses.

Steps such as this, coupled with *perestroika* will gradually expand possibilities for business. Growth will be slow. The primary limiting factor is the U.S.S.R.'s shortage of hard currency.

The Soviet market for industrial nation manufactured products is only about $12 billion annually; 90 percent of that market is held by European companies. U.S. exports have only about a 3-percent share of this market, much less than we have globally. The best prospects for U.S. export growth will come from increasing the U.S. share of the market.

The Soviet market is a tough market. It is not for the trade neophyte; it is not the first place to go. Winning contracts is drawn out and costly. Signing one's first business deal could take two or three years. It can involve numerous costly negotiating trips. Then you have the problem with language, technical translations, and different standards. These costs and demands are beyond the resources of most small businesses.

This is not to say that every contract takes two years or that no small business can succeed. There are contracts that are quickly arrived at, and there are small companies doing good business. But these are the exceptions, not the rule.

Some small companies can also find an avenue into the market by using experienced trading companies or representatives. Others may be able to link up as sub-suppliers to Western companies doing business with the Soviet Union.

Many, however, will do well to look elsewhere for profitable export markets. In any case, we, in the Department of Commerce, stand ready to help. We will be very glad to take your questions, sir.

[Mr. Laun's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much.

Dr. Lotarski, I take it you don't have any independent testimony, you are here to assist.

Mr. Laun, on page three of your testimony you state that the West's ability to influence the success or failure of *perestroika* and other reforms is limited. In a recent article in the International Economy, September/October 1988, Commerce Secretary Verity stated that the West can and should provide encouragement for those reforms that increase individual freedoms and decisionmaking, such reforms are in our interest. It is certainly not in our interest to see them fail.

Now given these two statements, what can or should the United States do to encourage these reforms? For example, Mr. Vargo in his article in Business Week in July 1986 stated that one way is through export promotion assistance.

Mr. LAUN. Right. I think the statement that the West really couldn't change what is going on in the East is basically a statement made by Secretary Verity at the East-West Conference at Pottsdam.

That refers to the overall success or failure of the Soviet system; it's not within our power. We have such a tiny part of the exports going to them; in the financial area the loans are a tiny percentage; we are a minor supplier. The Japanese and Europeans do an awful lot more than we do.

As far as encouragement is concerned, we have an overall program—I have a little lapel button here, "Export Now," in which we are trying to encourage American companies, showing them how Commerce can help and showing what opportunities are abroad. Yet many American companies have traditionally been too locked into the U.S. market to look out to other parts of the world.

One of the things that we are trying to do is to encourage the sophisticated American companies to get involved. We're encouraging small businesses to talk to other partners that they can get involved with to make sales.

So I think that we should work with them. We have the sectoral business groups that were set up as a result of the April meeting with the Soviets. And even now, this week in Moscow, one of those groups is meeting and trying to see what we can do in five or six of these sectors. These things do encourage trade by getting the Soviet people to come into our business offices.

We've had meetings recently where our General Counsel Brumley went to the Soviet Union and met with a group of Soviet lawyers for the purpose of finding out what is in each other's laws that we need to know about so that we can do more business.

We're not trying to give away the store. In a sense, we're trying to do anything we can in the non-strategic areas in a friendly way to see if we can improve trade.

Chairman LAFALCE. What is the Commerce Department or the Reagan administration position on the extension of Western private commercial lending to the Soviets? Should we limit these credits only to tied loans? What's the possibility of developing a joint allied approach on this issue?

Mr. LAUN. Our overall policy is that lenders should exercise "prudence." We think that should be underlined at all times.

And we think also, of course, that there should not be subsidies to that area.

At the same time we don't oppose lending on commercial terms, as we do have a free enterprise system here and we're not engaged in economic warfare. So we think lending on commercial terms is OK.

I would feel that the enhanced monitoring of commercial lending that we have been doing would be advisable. Also, while most of the loans that have gone out in recent years have been untied, there is an increasing extension of tied loans lately. I don't think we have a policy on that. There's no U.S. Government financing going on now. We believe that commercial banks, as long as they're operating within the guidelines of our laws, should be allowed to do things there.

At the same time the percentage is kind of small. I think U.S. banks have only about 2 percent of the Soviet Union's outstanding debt.

Chairman LAFALCE. You say that the banks should exercise prudence, give loans linked to specific projects?

Mr. LAUN. We think they should. At the same time they're not supposed to be lending into non-strategic areas.

Chairman LAFALCE. They're not supposed to be lending into non-strategic areas?

Mr. LAUN. They're supposed to be lending only in non-strategic areas.

Chairman LAFALCE. Oh, they're supposed to be.

Mr. LAUN. Supposed to be lending in non-strategic areas. Most of the loans were non-tied until recently. We feel that is up to the prudent banks to decide which way they want to go on tied versus untied.

Chairman LAFALCE. The prudent banks loaned an awful lot of money to underdeveloped countries in the world and it turned out to be fairly imprudent. And now these countries have received no new monies since approximately 1982 whatsoever for the purpose of growth, really only for debt service requirements.

I'm wondering if it wouldn't be appropriate if we see huge increases in commercial lending to the Soviet Union that's untied and unconditional to try to coordinate our policy with respect to that with these commercial lenders.

Mr. LAUN. I think that is an area that is not really a primary Commerce Department area; the Treasury Department really has the control over that part of the decision. I think I would rather defer to them to answer that question.

Chairman LAFALCE. Is there a goal that the Commerce Department has with respect to increasing the American share of the Soviet market? You've said you wanted to increase it, have you set any goals, and if you have set any goals have you developed a strategy for achieving that goal or is it pretty much a laissez-faire approach you are taking?

Mr. LAUN. Our approach overall is that we don't have a target set for each country, Soviet Union or any other country.

Chairman LAFALCE. But what is our market share now with trade with the Soviet Union, about 3 percent?

Mr. LAUN. About that.

Chairman LAFALCE. The European communities have around 90 percent?

Mr. LAUN. Yes. For example, in terms of goods and services with Canada, we do $166 billion trade a year. Now that compares with $2 billion with the Soviets.

Chairman LAFALCE. I appreciate that.

Mr. LAUN. We have offices, as you know, in nearly all of the States of the United States. We have an office in the Soviet Union, and we have offices in almost every other major country in the world. And we're fanned out on all of these to help American businesses go forward. We're not trying to push American business into an area; we're trying to encourage American business to look beyond its borders. If they will look beyond their borders, we're going to help them.

In that area they need a lot of extra help because doing business is so darn complicated in the U.S.S.R. There are so many bureaucracies and problems that they have to go through.

Chairman **LaFalce**. Is Commerce exploring a bilateral investment protection treaty between our two countries, because if there's a joint venture arrangement you're going to be talking, probably, about investment in those countries, and yet with a difficult political situation the American investor might be very unprotected there?

Mr. **Laun**. We are not considering that.

Chairman **LaFalce**. Mr. Campbell.

Mr. **Campbell**. Thank you, Mr. Chairman.

Mr. Laun, on page three you mention that there is a requirement for joint ventures with the Soviet Union that they have to export to the West.

It's my understanding that there have been some inroads made by American companies seeking joint ventures with the Soviet Union. These have been primarily soft drink companies, fast food companies, and things of that nature. Can you tell me what kind of arrangements they have, because I would assume they don't export to the West?

Mr. **Laun**. There is a consortium that has been attempting to set up something that would reach that also. In other words, to be able to have a consortium in which some people export to the West and others are able to operate within the community.

My understanding, even on the soft drinks situation, is that they have an arrangement that ties in with Vodka sales to the West.

Chairman **LaFalce**. Mr. Slaughter? No questions.

Mr. Bilbray.

Mr. **Bilbray**. Yes. Mr. Secretary, dealing with the Soviets through the other committee, I serve on the Foreign Affairs Committee and the Trade Subcommittee, I did have various meetings in both Moscow and Kiev with Soviet leaders as to trade.

One of the things that was brought up to me very clearly in the Ukraine by Ukrainian leaders was that they wanted to deal separately from Moscow in dealing with the United States. Ukrainian leaders repeatedly told me that if we would bypass Moscow they could make a much better deal with us than the Russians would.

I don't know if this has been played upon—are we dealing directly with the different republics, their trade ministers, and so forth? Or are most of our companies still dealing through the central party mechanism in Moscow?

Mr. **Laun**. They set up this 100 different organizations to do business with, and believe me that's complicated. You can't even get a phone book at this point to know which ones to call.

I think some of the people in some of the ministries don't know who is doing what in some of the other ministries. Before it was one, the Ministry of Foreign Trade, and now it's broad.

Dr. **Lotarski**. Not in the Ukraine, but there is at least one American company that has, in the last several months, signed a contract with a Republic authority. That is an area where a number of Republics in given spheres of business have the authority to sign contracts. And they are quite interested in it. It is something that we are looking at and trying to establish these contacts, and in fact some of our companies are dealing with the Republican authorities.

Mr. **Bilbray**. Were those in the Baltic Republics?

Dr. **Lotarski**. No.

Mr. **Bilbray**. One of the things that's interesting is that, especially with the Ukrainians, when dealing with them I brought up some of the same points the Secretary had brought up. Of course, I recognize that we're trading soft drinks for Vodka as part of the earlier joint ventures.

But concerning lack of reliable suppliers within the Soviet Union, or of being able to take American capital or invested capital out of the country, you don't want to keep having to plow all of these things back in. The Ukrainians claim they will be willing to work with us to correct those problems as their positions are not set in concrete.

Their comments were basically that we know who the Russians are, but we're better to deal with. It was a very progressive movement in the sense of wanting to break the economic ties of having to deal through Moscow.

Have we had any attempts from the Department of Commerce to deal directly with Ukrainian leaders?

Dr. **Lotarski**. One of our interests in the working groups that we have established in the sectors is to, in fact, have participation by people from the various regional organizations, from the Ukraine, from some of the other Republics as these meetings go on; and we're very interested in that and we have indicated that we would like to have that happen.

Mr. **Bilbray**. There's been contact, but has there been any recent exchanges of American businessmen, business consultants, or governmental groups with the various Republics in any other sense than informal exchanges?

Dr. **Lotarski**. There are a very large number of exchanges of groups from different cities, different areas, different businesses. In fact, we have a hard time keeping up with many of them that are arranged.

Mr. **Bilbray**. When I came back from Kiev I was debriefed because I was one of the first Congressmen into Kiev after Chernobyl. As I am from Southern Nevada, the radiation problem doesn't affect me as much as it would most people having been, as I was, born with atomic bombs blowing up 50 miles away from my home. Do we debrief most of these businessmen as to overtures, because we recognize that often messages are sent out of the Soviet Union in strange ways? In my case, some of the Department of State people whom I met with felt that the messages given to me from the Ukraine were messages that were meant to get back and start some sort of movement going.

Do you debrief private businessmen as you do government officials?

Mr. **Laun**. We certainly do. I think that is one of the things that is very interesting. There used to be only one river going out there, now there are all sorts of little rivers; and we try to do as much as we can to keep in contact with all the businesses. For example, the group that is over there now, has not only some of our trade development people and people from my office, but also has people from the Trade Associations representing business, to try to see within each sectoral area just what we can find out. What's going on in the Republics? What's going on in Moscow? And are there other little rivers that we can get going.

Mr. **Bilbray**. I see.

Thank you, Mr. Chairman.

Mr. **Slaughter**. I would like to ask, to what extent the Europeans from the West have had a history of dealing with the Republics in trade relationships?

Dr. **Lotarski**. Until recently nobody has been able to deal with anybody except the central authorities. So in that sense the *perestroika* is to our advantage because there we start out on an equal footing. There are new people, new organizations, new people around the country entering into foreign trade—everybody else has had as little contact with it as we have.

Mr. **Slaughter**. Thank you.

Mr. **Laun**. As I mentioned before, even the Soviets don't fully understand the situation; there is confusion there. You can't get a phone book that can tell you whom to call about things. And individual ministries don't know what's going on in the other ministries. So it's uncharted waters out there right now.

Chairman **LaFalce**. That's one thing the United States Government is very good at, putting out phone books. I mean, ask any administration what we do to permit exports and they'll give you a phone book.

Mr. Lancaster.

Mr. **Lancaster**. I have one question. What trade fair or exhibition opportunities are available now for American business people to expose their products to Soviet buyers? Has anything been organized or is anything in the works?

Mr. **Laun**. Yes. We have had three past ones. I'll let Susanne tell about the future ones. We had one on oil and gas equipment and on food processing, and something on construction that has already gone on over there.

Dr. **Lotarski**. We just decided for next year to, in the spring, sponsor a U.S. pavilion at the tourism industry exhibition which will involve restaurant and hotel equipment.

Chairman **LaFalce**. Where is that going to be held, Susanne?

Dr. **Lotarski**. That's going to be in Moscow. And catering equipment, management systems, camping grounds facilities, something which the Soviets have a great deal of interest in increasing—improving their tourist facilities, so we think it's going to be a good deal.

Mr. **Laun**. One of the things that these five sectoral groups that are going to be meeting now and throughout the fall are going to be looking into is, what are the other opportunities for that sort of thing.

Mr. **Lancaster**. I would certainly encourage more of that.

Chairman **LaFalce**. Would the development of special economic zones facilitate the development of small business in the U.S.-U.S.S.R. trade?

Mr. **Laun**. First of all, on special economic zones we're trying to work our way through as to exactly what that means. In other words, it's a new idea they have come up with.

Chairman LaFalce. They have been creating them in connection with what, the Chinese and the Japanese?

Mr. Laun. Yes. In Hungary, Bulgaria, and some other places, they've had them. There is no one solution but they talk about joint ventures, special economic zones, or this and that. Each one of those is sort of floated out there and it takes a lot of work to make it work.

Small businesses, sure some small businesses get going there. This week, for example, you read in the papers yesterday that there's an Arizona group, I believe it is, that is going to have some copying centers available in the Soviet Union, and even tying it into a fax situation. That's something you might have gone to the Gulag for if you tried to set up a few years back.

But there are some niches, and things like that can happen. But basically the small business that goes over there with stars in its eyes with "Gorby fever" and feeling now is the time to go to the Soviet Union but is not well prepared for it, is making a serious mistake. You might as well buy a lottery ticket, in a sense, as to do that.

That's why we have to work very, very closely with anybody who wants to go there, to make sure they're pointed in the right direction, that they have the right friends. That they realize what they're going to have to go through.

So while we're promoting trade we're not, in a sense, advocating kamikaze runs in this area either.

Chairman LaFalce. All right. And it's good that we be pragmatic in this.

Mr. Laun. Exactly.

Chairman LaFalce. But on the other hand we don't want to miss any lost opportunities.

Could the United States support membership or observer status for the Soviet Union in GATT, and if so, under what conditions might we be able to do something like that?

Mr. Laun. We are opposed to the Soviet admission to GATT. We have opposed it right straight through. They had a recent meeting with Deputy U.S.T.R. Michael Smith in which that was told to the Soviet government.

The reasons for this are economic and not political. The Soviet Union is not a market economy. Their prices are not determined by market forces and everything is controlled administratively. There isn't any market price mechanism. And all the things you talk about in the GATT require a market economy to work. So we didn't have anything to talk about.

Now they say that they're going to get there and so forth. We've said, more pragmatically, that we would like to see progress toward getting there, actually, before letting them come in. So we're opposed.

Mr. Bilbray. Mr. Chairman, would you yield on that question?

Chairman LaFalce. Yes.

Mr. Bilbray. I was wondering, what other eastern block countries at the present time have observer status at GATT?

Dr. Lotarski. Actually, members of the GATT include Poland, Czechoslovakia, Hungary, and Rumania, and Bulgaria as an observer.

Mr. Bilbray. The logic there, though, is the fact that if those countries are part of GATT it seems arbitrary that we will not allow the Soviet Union, at least on an observer status, to be part of GATT; not as a full participating member. I mean, those eastern block countries may be a little more progressive when it comes to the market system than the Soviet Union, but they're certainly not what we consider to be open markets.

Mr. Laun. They're not open markets, but they do have price mechanisms working a lot more than they do in the Soviet Union. You're also allowing a pretty big player at the table if you allow the Soviet Union.

We are in discussion on this with them at all times, but we're not trying to throw up road blocks.

Mr. Bilbray. Is the whole purpose of GATT to not allow big players to come into the system?

Mr. Laun. No.

Mr. Bilbray. To be an exclusionary system. I mean, that statement gets me a little bit.

Mr. Laun. A player has to be in the system. A player, no matter what their size, if they're in the system works in GATT.

Mr. Bilbray. What is the significance of an observer position in GATT rather than——

Dr. Lotarski. An observer is supposed to be a country which has begun undertaking the obligations of the GATT. It's preparing itself in a serious way. And it has moved part of the way toward it already.

In fact, the GATT has been looking quite seriously at what an observer status is supposed to do and has not been admitting observers for some time.

As far as the East European countries, I mean, one in terms of they are much more involved in the international trade world than the Soviet Union. But I think in part it is our experience also with the East European countries and how difficult it is to obtain reciprocity, to have what we extend to them, through the GATT, reciprocated, which increases our concern about countries which are unable to reciprocate our GATT.

Mr. Bilbray. Has GATT come even close to allowing Members of Congress or members of Parliaments to observe their proceedings? I know in the past they've virtually excluded any members of Parliament or Members of Congress from their proceedings. I know Don Bonker was outside and they actually canceled the meeting because he wanted to come and look. Will they let businessmen come in and sit and observe without participating? Are they still exercising that policy that no Parliamentarian can view any proceedings of GATT?

Mr. Laun. I don't know. It's an interesting question.

Mr. Bilbray. I know that it was their past policy, and I know there has been some real hard feelings over that.

Mr. Laun. I think if Don Bonker couldn't get in that must be their policy, I guess.

Chairman LaFalce. Mr. Laun, Dr. Lotarski, I want to thank you very much for your contribution.

We will go on to our next panel.

Mr. Laun. Thank you very much.

Chairman **LaFalce**. We will now hear from Dr. Marshall Goldman of the Russian Research Center at Harvard University and Mr. Eugene Milosh, the president of the American Association of Exporters and Importers.

Dr. Goldman, please.

TESTIMONY OF MARSHALL I. GOLDMAN, RUSSIAN RESEARCH CENTER, HARVARD UNIVERSITY

Mr. **Goldman**. Thank you.

Mr. Chairman, I'm Marshall Goldman from Wellesley College and the Russian Research Center.

First, I should apologize for not having a prepared statement. I have recently returned from the Soviet Union and found out about the invitation to speak without enough time to prepare.

I would like to echo some of the things you've just heard. However, I think it's necessary that when we talk about American-Soviet trade, we keep it in perspective. The majority of the trade that we have with the Soviet Union, particularly our exports, are mainly agricultural in nature. There's really not much in the way of machinery or manufactured goods.

More than that, the level of our trade, particularly in recent years when it is not affected by embargoes, is determined mainly by what happens in the Soviet harvest.

Last year, for example, the exports of the United States to the Soviet Union measured in rubles was about 900 million rubles which was about $1½ billion. That compares to 1984 when the level of our exports was three times that level. It was about $4.8 billion. The imports in that period of time were about the same. What accounts for the difference?

In 1987 the Soviets imported 30 million tons of grain. In 1984 it was 55, almost 56 million tons. So really, it's the level of grain imports into the Soviet Union that determines what happens.

Second of all, you have to consider what happens to Soviet oil exports. The Soviet Union is the world's largest producer of petroleum and periodically, depending on what OPEC is doing, either the largest or second or third largest exporter of petroleum.

And obviously, when the price of petroleum drops it hurts not only Saudi Arabia, but it also hurts the Soviet Union. Right now the price has been dropping, and that is also a consideration because the Soviets like to balance their trade even though they are running a slight deficit.

This year it looks particularly bleak for the Soviets. There have been reports in the Soviet press about the fact that harvest conditions are quite serious. Agronomists say they have not seen conditions like this for 20 to 30 years. And officially on September 1st a spokesman on Soviet television reported there will be less grain harvest this year than last year. Last year was a relatively good year, but this year even though our Department of Agriculture estimates that the grain harvest will be 205 million tons compared to a goal of 230 million tons, it's likely in my estimation to be below 200 million tons.

For example, in Krasnoyarsk, which is where Gorbachev was visiting recently, the report is that one-half of the grain is lying down in the field and that there was hardly any summer this year; fall came in just when summer was supposed to have begun, which obviously is not good for the crop.

I maybe fall into the roll of being a pedantic, but let me say something about what the nature of the reform is, so that you have some idea of what is involved. You have to look at the internal changes in order to understand what is going to happen ultimately with the foreign trade sector. I'll focus primarily on *perestroika*, the economic changes as opposed to *glasnost*.

The first thing is that Gorbachev wants to reduce the state sector. This calls for a reduction in the role of the center, a reduction in the role of Moscow. Instead, Gorbachev wants to increase the role of the Republics. He wants to reduce administrative orders from the center where enterprises are told what to do; when to do it; and how to do it.

This means increasing then the role of the state enterprise, letting them make their own decisions and more importantly telling them they have to be financially self-sufficient.

This is a significant change. If you're going to reduce the role of the center that means you're going to have to provide some substitute and that means increasing the role of the market, as we understand it, not as the Soviets have understood it in the past. That also means allowing private business. Private business is now legal in the Soviet Union. Cooperatives are now legal in the Soviet Union and do seem to be flourishing within the Soviet context.

Leasing arrangements have now also been authorized. Individuals, cooperatives can now lease shops, manufacturing activities from state enterprise; they can also do that with state farms. Gorbachev has recently said the peasants could lease the land up to 50 years.

They are now talking about the return of private farming into the Soviet Union. They are even now talking about alternate sources of financing. Corporations with stockholders. Forming independent banks, although usually still controlled by the state.

There is even some rumor about creating a stock exchange, although not yet like anything we have seen in China. This summer I bought $35 worth of Chinese state bonds; that has not happened yet in the Soviet Union, but it's happening in China. Who is to say it won't happen in the U.S.S.R?

While these changes are very promising from our perspective they also bring some tough measures that will cause a lot of problems in the Soviet Union. For example, if you're going to have a market that means you have to have meaningful prices; there was some discussion about this earlier, having to do with GATT. That means price reform, which is the synonym for price increases which is a synonym for inflation.

It means you're also going to have bankruptcy because if the companies are not making money, then presumably they're going to close down. The Soviets now talk about forcibly shutting down plants that are not making money.

It also means you're going to have unemployment. If you are producing things that nobody wants, presumably you're going to have to close the factories down and get rid of some of the surplus labor that has been there.

You heard some earlier discussion about the changes in the foreign economic sector. The Soviets have actually abolished the Ministry of Foreign Trade; that's one way of getting rid of state control. They introduced a substitute, but basically it is no longer as strong as it was before.

And they will allow enterprises to make their own contracts, exporting and importing. They've also set up joint ventures. As you've heard, they're talking about convertibility which is one of the reasons they want to join GATT, IMF, and the World Bank. And they indeed are talking about that in a very serious way.

What are the problems? This is clearly not an easy undertaking. This requires a turn in ideology that would be hard, under the best of circumstances, and these are not the best of circumstances.

First of all, there's a problem of ideology. While private business is legal you cannot hire anyone; you can only have the members of your family, which of course imposes an immense restraint. You can hire people in cooperatives and some of them now are as large as 200, not like the 2,000 in China, but nonetheless, 200 is still a pretty large sum given what the Soviets had said before about hiring other people in the private or cooperative sector.

One of the severe limitations in joint venture expansion is that foreigners can only have a 49-percent interest. That poses very serious constraints.

Second of all, in the joint venture side, if you're going to repatriate profits they must come from hard currency exports. They don't have to be just to the Western world, it could be to anybody who is willing to pay convertible currency.

The trouble is that the Soviets are running joint ventures as a milk cow and you can only do that if you feed the cow grass and there's not much grass there. So people aren't responding. My estimate of the number of joint ventures is only about 50, not even 60. It has been legal now for 1¾ years to do this. There are hundreds of letters of intent, but very few actual joint ventures that are running and those that are running are running with their hands tied and their feet locked in braces, for the most part.

There is still the feeling that the people hate Gulags in the Soviet Union. People who, in agriculture, are doing well. So that's one of the reasons why even though you can sign 50-year leases there are very few that are signed. The peasants are hesitant, they don't want to be put in a position where, what will happen to them is what happened to the peasants who ended up in the Gulags in the 1920's. You see discussions of this in the Soviet press.

There is worry about unemployment. That's a breach of the social contract. Things haven't been great in the Soviet Union but they never had to worry about unemployment until now.

There's also talk about price reform, and that means inflation. And if you have shares of stock that means exploitation, the kinds of things the Soviets have criticized the West for.

Also there's a cultural problem here, and I don't want to get into stereotypes, but the Russians find some of these things difficult. They resent income inequality. The story that was being told that I heard in Moscow this month was that a Genie comes and gives us three wishes. An Englishman is asked what he wants. He says I want my little cottage on the seashore. The Frenchman is asked what he wants. I want my vineyard and my mistresses. And the Russian when asked answers my neighbor has a goat, I don't have a goat, kill my neighbor's goat.

These are very strong feelings that are held. And indeed there has been a rash of arson in the Soviet Union of cooperatives. 50 percent of the cooperative restaurants in Moscow have been threatened with arson if they don't pay off to the mobsters. Five have actually been burnt; one, three times.

There are also political protests, that is——

Chairman LAFALCE. Please, I have a citizen in my District who speaks fluent Russian and wants to open a restaurant in Moscow and I was curious——

Mr. GOLDMAN. I will repeat it. Of the cooperative restaurants in Moscow, which I know are growing, there may be 50 to 75; 50 percent of them have been threatened by mobsters with arson unless they make a pay off. Five restaurants have actually been burnt. One has been burnt three times.

There was another article in *Moscow News* about a cooperative venture to raise pigs to provide meat which is in short supply. That piggery was set on fire three times; the third time it burnt to the ground.

As far as the political parties go, protests have become a part of *glasnost*. This again is an unprecedented kind of thing. There is fighting among the nationalists, not only in Armenia but also in the Baltic states. People are resentful of one another, and indeed the whole area of one Republic trying to get a jump on Moscow is now universal policy.

I met with some people from Lithuania who have virtually formed an independent party and some of the people in that group are talking about cessation from the Soviet Union as they are in Armenia. And if you look at Armenia today you will see that the newspaper announces that Armenia is out of control of the central authorities. There is now an independent group running Armenia, at least for the time being.

And not only is there tension and struggle between the different nationality groups there is struggle now breaking out between classes. The peasants are complaining that they have been exploited for 70 years and the country has been built on their backs and they're not getting anything in return. And when you say that, then the people in the city say, what are you talking about. In the case of Karaganda, for example, the local party official at the party conference in June said that, when his people want food they have to travel 200 kilometers to find food. So where is all the food going?

All these problems are coming out and clearly impinge on and impede the development of *perestroika*.

Chairman LAFALCE. They sound so formidable, you wonder if there's much hope for success of *perestroika*.

Mr. GOLDMAN. You bet your life. That's exactly the problem that Gorbachev has to face. I'm giving you more than you probably want to know about this.

Chairman LAFALCE. No, no, I find this fascinating.

Mr. GOLDMAN. Let me tell you it is fascinating. But I want you to understand the odds of what he is trying to do, because clearly this is not something that is winning universal support because of the problems. And indeed, the criticism of Gorbachev is probably keener now than it has ever been before.

If you had a chance to see some of those television scenes of his visit to Krasnoyarsk last week, you will see that he was verbally abused in a way that even Dukakis and Bush have been spared so far. It is really an amazing kind of thing.

Chairman **LaFalce**. You mean *glasnost* is succeeding more so than *perestroika*?

Mr. **Goldman**. It is, absolutely. And indeed, it encourages it because more people now hear about problems elsewhere that whereas before they thought this was only my problem; I didn't realize it was going on outside my district and now I hear about it all over. So it's the thing to complain now.

There's a certain puffery in that which you've got to discount. But there are real problems. Some of the economists we met with in Moscow in the early part of September were saying things are worse now than they had been before Gorbachev came along, which is not what was supposed to happen at all in the system.

But let's assume Gorbachev is successful, let me change the tone here, because indeed if we're going to talk about joint ventures and these things we have to assume that he's going to be successful. At least that he's not going to be fired, whatever that means.

First of all, in terms of the regular foreign trade activities there are some prospects here of improvement. Again, it depends on the price of oil and again it depends on the harvest.

But there has been an improvement in sales and contracts from some of the businesses in Moscow. We met with them, again, three weeks ago, and a company like General Electric has indicated, for example, that its sales volume is doubling now. It's doubling from a relatively low base, but it's doubling.

And more than that, for the first time in all the time that General Electric has been in Moscow trading with the Soviets they are being given access to their equipment once it is sold. In other words, they have been providing turbines all these years, but they have never been able to see these turbines in operation. So they couldn't maintain them and they couldn't tell whether or not there should be enhancement or change for Soviet conditions. They are now being given that opportunity.

If, after all, you can see where the missiles are being made, you should be able to see where the turbines are operating.

The biggest opportunity, I would agree, however, is with the nonregular foreign trade and that's joint ventures. Here, of course, we have to make some assumptions that the role of ideology is going to improve or that it indeed will diminish. That has been happening in China. In China you can own 100 percent of your investment, of your venture, which of course is not a joint one then. But the Chinese even so are still inhibited by some problems.

But ideology gradually erodes and it may very well be the same thing will happen in the Soviet Union. For the time being, however, the 49-percent restraint on foreign investment is still a barrier.

Also, foreign businessmen are still harassed. There is an article about some Russians who were arrested because they had given the sales plan of their Ministry to a Dutch businessman. There was also a report of an American businessman in a similar kind of difficulty. You still don't want to mess with the KGB.

The offices outside—I mean, the American Commercial Office still has a policeman in front of it. I was stopped two weeks ago trying to get in. The policeman knew I was an American, he stopped me anyway just as he would stop Russians. So I would disagree with the testimony earlier; things have not improved that much.

There is talk of special economic zones. However, they are very difficult propositions right now, largely because there's considerable fear that if you set up special economic zones in Lithuania, Latvia, Estonia, for example, or even in Odessa, this will lead to fights among the different Republics and cause them to splinter off from the Soviet Union.

But there is considerable interest in some of the Republics about linking up with businessmen from outside the Soviet Union, and indeed, trying to do things outside of Moscow's control, although Moscow still has some control.

In the case of Lithuania they're talking about establishing their own economic relations with the common market, with other countries. They want to break out from Moscow. But still it's going slowly.

I said, after 1½ years now there are still only about 50 joint ventures that are operating. There are some powerful people in the Soviet Union who are very opposed to the whole process, particularly Ligachev, the number two man. Ideologically he has announced he is opposed to the market system. He asked what has happened to the class struggle. The KGB, as I said, still is very much involved in all of these things and it is not going away.

What is happening, in other words, is that there are two different processes at work. There was a man who rushed into the hospital in Moscow, he said, I've got to see two doctors, one for my eyes and one for my ears. And the attendant said, why two doctors? He said, well, my ears are hearing things my eyes aren't seeing.

What does this mean for the United States?

What it means for the United States is that trade, first of all, is not necessarily a barometer of peace. Better relations have now taken place without any increase in trade. As I mentioned, indeed, last year trade dropped. And, of course, we should always remember that France and Germany were major trading partners before World War II.

At the same time, however, at a time of real reform, as there is now, it seems to me it would be in our best interest to encourage trade and to treat it with respect, and to treat this process with respect.

I think Reagan has done that in Arms Control, even though he may be surprised himself that he has moved this way in the last eight years. And I think we should do the same thing in the case of trade. That doesn't mean we give away the store, but it does mean that we should award good behavior.

I think the trade should be used for improvement in other political affairs. I think that indeed as the number of dissidents in prison is reduced, and it's reduced sharply now, and as the number of people refusniks are allowed to immigrate increases, I think we should start talking to the Soviet Union about issuing a waiver on Jackson-Vanik. We should also talk about liberalizing credits. Give them Most Favorite Nation status.

My own feeling is that having Most Favorite Nation status won't make a bit of difference in terms of increasing sales volume. It has not, when the Soviets have Most Favorite Nation status with other countries. It's more a sign of prestige and a change of tone and I think it's something that Gorbachev could use right now.

Let me conclude. Ultimately success will be decided inside the Soviet Union itself. I do agree very much about that with the preceding speakers.

Foreign trade is more a symbol than it is of a major factor affecting the success of the reforms. But Gorbachev has to improve quickly and anything that he can do—any success that he can achieve will be important for him. Already he's been in office now for 3½ years, and things economically have not improved and indeed some people say they have deteriorated.

The poor state of the situation economically in the Soviet Union helps to explain why a man went into a bar and asked for a pitcher of beer and the bartender said it would cost a ruble. And the man said, "A ruble? I was just here a little while ago and it only cost me 50 kopeks." And the bartender said, "Well now we have *glasnost*, you have to pay 50 kopeks for *glasnost*." And the man said, "Well, OK, I like *glasnost*, here is my ruble." But then the bartender gives him 50 kopeks change and the man said, "Why did you do that? You just told me I had to pay 50 kopeks for *glasnost*." He said, "Yes, but we don't have any beer." Thank you.

Chairman LaFalce. Perhaps a slightly different perspective will be heard from Mr. Eugene Milosh, the president of the American Association of Exporters and Importers.

Mr. Milosh, please.

TESTIMONY OF EUGENE J. MILOSH, PRESIDENT, AMERICAN ASSOCIATION OF EXPORTERS AND IMPORTERS

Mr. Milosh. Thank you, Mr. Chairman.

Beyond broad policy implications, from a businessman's standpoint, there have been serious practical barriers and misunderstandings that have been encountered by the business community through the years in dealing with the Soviet Union.

Because these problems are real, faced every day on an operational level, I think it's important to mention some of these to determine if *perestroika* can indeed overcome these barriers or if the principles of *perestroika* can somehow be modified and expanded to accommodate business concerns.

Some of these are horror stories from the 1970's which should not be repeated in the 1990's.

Fundamentally, U.S. suppliers entering the Soviet market are faced with many subtle protectionist tendencies. With the Soviet inconvertible currency, hard currency must be allocated by industry or Ministry, leaving a U.S. supplier at the bottom of the list unless there is a special priority for his particular product, spare part, machinery, or technology.

While availability of credits from the West could partially mitigate the situation, which is limited under Jackson-Vanik, a U.S. supplier still is not on the same level as a Soviet enterprise selling to another enterprise or a supplier from eastern Europe, despite apparent quality advantages.

Even more striking is the structural passivity that has existed in Soviet exports. A Soviet enterprise is unable to reach out and comprehend world market conditions and without incentive to earn hard currency for their own account were placed in a semi-conscious state of slumber, which is apparently now being addressed.

Furthermore, denying importers and purchasers access to factories where decisions might be made locally, further insulated the possibilities of redesigning products, modernizing plants, and adapting to market conditions. In this context, the role of U.S. importers, retailers, and subcontractors should not be minimized as a means to growth. This has been particularly maximized in the PRC and some countries of eastern Europe for consumer type products.

I think the point is instead of placing too much emphasis on a handful of large projects, exemplifying national pride and massive achievements, it would be more prudent and beneficial to proceed on a variety of smaller ventures and business transactions that have a greater chance of success and in the aggregate would be more beneficial to the economy.

And certainly with regard to the political and trade law hurdles which are large, a broader approach would have inherent advantages.

Other negative operational behavior is prevalent in the Soviet Union and I'll just mention a few of these, is that U.S. firms frequently relegate responsibility for Soviet trade to European affiliates or distributors, thereby losing opportunities for direct contact and the benefit of direct exchanges. It distorts some of the trade statistics that were mentioned here earlier, especially sales through Europe.

Soviet organizations with restricted authority to reach out are also comfortable dealing with middlemen and intermediaries who serve a useful function, but are sometimes of questionable repute. And there are all kinds of stories, horror stories on that which I have in my statement.

To bid on contracts, U.S. firms invest heavily in proposal preparation to meet Soviet standards. This requires detailed design, engineering, equipment specifications, and pricing breakdowns. Since the Soviets usually do not pay up front for proposal preparation and bidders are kept in the dark, many firms are vulnerable to whipsawing and compromising technology and know how.

The Soviets fear the United States is an unreliable supplier because of policy interference inconsistencies in export control regulations and because of experiences of off-spec, beyond shelf-life, and inferior quality deliveries. The latter can be attributed to over aggressive bidding, one-shot deals, and the practice of purchasing without technical assistance and start-up provisions.

There are a great deal of stories, I'm sure you've heard, on lack of hospitality accorded Western businessmen which currently involve exorbitant fees for hotels with services on the decline. A frustrated businessman seldom returns to be intimidated, only large project oriented firms having staff commitment and possessing resources allowing for greater patience and endurance can afford to do so.

Not surprisingly then current results of *perestroika* in accommodating the needs of business are so far lackluster despite Soviet pronouncements, and extensive media coverage.

During a 4-year transition period there are signs of progress, hopes for progress, but for the firms involved in trade little improvement and much chaos.

For instance, U.S. firms find it even more frustrating in dealing with Soviet officials. Since approximately 40 percent of the staff in the Ministry of Foreign Trade, once a corp of elite, have or will lose their jobs, confusion prevails.

Joint venture regulations, although relaxed, are limited in application and interest due to lack of ruble convertibility and confining possibilities for repatriation of profits in dollars.

Basically, joint ventures are attractive to large firms willing and better able to speculate investment in order to obtain the future foretold in the Soviet market. And this really means waiting for ruble convertibility, which most economists on a United States and Soviet side say will take anywhere from five to 10 years.

I might say that joint venture approval is more relaxed and decentralized in that the Republics can now negotiate joint ventures, but there are approval processes which are required back in Moscow.

Chairman LaFalce. Let me interrupt you for a moment. Do either of you have time constraints? If we are to recess this for approximately 15 minutes and then return, would it cause you inconvenience?

Mr. Goldman. No.

Mr. Milosh. But we could wrap up in just two minutes, if that would be easier for the committee.

Chairman LaFalce. Dr. Goldman?

Mr. Goldman. I'd like to catch a 12 o'clock plane.

Chairman LaFalce. Let's try and wrap up in five minutes.

Mr. Goldman. Very good.

Price reform under *perestroika* is still years from reality. Presently there is a dual pricing system prescribing state allocations based on contract prices and does not make for an internal distribution system relying on market principles.

Let me just get to the summary of what are some of my thoughts.

Given all the commitments to *perestroika* embraced by Mr. Gorbachev it still appears uncertain in terms of its effect and the ability of the Soviet Union to conduct international trade with the West. It's a period of testing.

Under these circumstances it is incumbent upon the United States to encourage the expansion and faster pace of *perestroika* rather than encouraging U.S. business to leap into a confusing situation whose outcome is uncertain.

There are many things we can do in the meantime. I would suggest encouraging restructuring under *perestroika* to apply to international trade as well as to the domestic economy. Improve trade facilitation in services; this is already underway.

Develop a policy toward GATT membership. There are many novel approaches being discussed. And with *perestroika* advancing and with the coming of 1992 I think the United States should start a dialogue with our trading partners and take the advantage of creating an agenda.

But whatever approach is adopted it should be recognized that the GATT has as a principle objective the improvement of the world economic order.

I would also look at improving the role of the U.S.-U.S.S.R. Trade and Economic Council to represent small- and medium-size companies, and to update its mission in that respect.

Finally, the United States and our trading partners should welcome *perestroika* as a positive step in Soviet economic development. While at this stage there are limited opportunities for U.S. business expansion, there may be opportunities to reduce administrative and operational type barriers. Continuation of *perestroika* should be fostered, especially application of its principles to the conduct of foreign trade. Thank you.

[Mr. Milosh's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Milosh and Dr. Goldman. Because of the fact that we do have a vote taking place right now and because of the time constraints you have, I'm just making the judgment that I'm going to adjourn today's hearing, and thank you very much for your testimony. I think you laid an excellent foundation for us as we come to understand *perestroika* and what it means and what its potential might be.

I think you have pointed out to us that while there is potential there we ought not to have, as Mr. Laun pointed out, any Gorby fever or think there's going to be any magic wand that is going to enable American exporters to all of a sudden have a tremendous new market within the next year. So *perestroika* is going to have to be something that's brought about within the Soviet Union primarily, although I think it would be beneficial to us, if it succeeds. We could help it along, it probably would be wise. But it's not something that we should think is going to be a major solution to the United States trade deficit.

Thank you very, very much. I'm sorry we do have a vote right now but that's the real politic of the Congress.

Thank you.

[Whereupon, at 10:51 a.m. the committee was adjourned, subject to the call of the Chair.]

PERESTROIKA AND ITS IMPLICATIONS FOR THE UNITED STATES

FRIDAY, SEPTEMBER 30, 1988

U.S. House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359-A, Rayburn House Office Building, Hon. H. Martin Lancaster (acting chairman of the committee) presiding.

Present: Acting Chairman Lancaster; Representatives Sisisky, Bilbray, and Price.

Mr. Lancaster [acting chairman]. Good morning.

The Small Business Committee meets today to complete a set of hearings on the prospects for increased trade with the Soviet Union by American small business. The chairman has been detained in a Banking Committee markup this morning. I will be filling in until he arrives, and I would like to submit his opening statement for the record.

[Chairman Lafalce's opening statement may be found in the appendix.]

Mr. Lancaster. I do want to take this opportunity to commend Chairman LaFalce for his foresight in calling these hearings. The approach that Chairman LaFalce has taken is especially important. The time has passed when policymakers can afford either to give in to an abstract sense of euphoria that the Soviet Union has recognized the failure of socialism or, on the other hand, to declare that Soviet society will never truly change, and thereby ignore the opportunities offered by changes that do occur.

It is evident that General Secretary Gorbachev's changes are proceeding steadily. Even as we meet today, the Soviet Central Committee is meeting in Moscow, with an unexpected meeting of the Supreme Soviet to follow tomorrow. The purpose of these meetings seems to be an effort to drastically cut back on the size and inefficiency of the Soviet bureaucracy.

I believe our discussion of U.S.-Soviet relations must now move into a second stage, a stage which the business community reached long before the Federal Government. In this stage we need to become not pundits but hardnosed analysts. We need to find out what has to be done to help our small firms do business with the Soviet Union.

We need to ask the tough questions that our small businesses are asking: How can we help small businesses recognize specific niches for themselves in the Soviet market? How can we bring the know-how of small businesspeople to the attention of the Soviets, who are conditioned to look first to large businesses? How can we assist our small businesses as they seek to establish themselves where language, bureaucracy, and the rapidity of change itself are discouraging?

We are here today to ask these questions to a highly distinguished panel of experts. We have Professor Thomas F. Naylor, an economist from Duke University in my home State of North Carolina; Arthur L. George, a partner with the firm of Baker & McKenzie; and Tim Bruinsma, an attorney who is actively involved in both public and private trade endeavors in California.

Are there other Members who wish to make opening statements?

Mr. **Bilbray**. I serve on the International Trade Subcommittee of the Committee on Foreign Affairs, so I have been involved in discussions in this area. I have traveled to the Soviet Union, both to Moscow and Kiev, and by talking to various leaders, interest has sparked about the establishment of joint ventures and trade between the United States and the Soviet Union.

It is my hope that the United States will gradually increase its trade representatives within the embassy in Moscow, and we will open our consulate in Kiev.

I said to Mr. George before the hearing started, it is my hope that the embassy, the consulates, and the various republics in the Soviet Union, will have trade representatives to assist, not just the big businesses but also the small businessman that wants to get through the bureaucratic nightmare that is in the Soviet Union. The Soviet Union's bureaucracy is like none other I have seen in my life. Most small businessmen would have great difficulty in that quagmire for more than a few hours.

Hopefully, we will organize representatives in the consulates and in the embassy, similar to the USTTA representatives, that would enable American representatives that enter the Soviet Union and have somebody who would help to arrange their business days for them.

I appreciate the effort of the committee in this hearing. I hope the witnesses can provide us with some conclusions that will enable us, as a committee, to move forward to help small businesses deal not only in the Soviet Union but in the entire Eastern Bloc. Thank you.

Mr. **Lancaster**. Mr. Sisisky.

Mr. **Sisisky**. No statement.

Mr. **Lancaster**. I now introduce Dr. Naylor of Duke University for his testimony.

You may, if you wish, have included in the record your full testimony and summarize at this time.

TESTIMONY OF DR. THOMAS H. NAYLOR, PROFESSOR OF ECONOMICS, DUKE UNIVERSITY

Dr. **Naylor**. Since the February 1986 Party Congress in Moscow, Soviet leader Gorbachev has repeatedly called for radical reform. However, since he has neither denounced Marxist-Leninist ideology nor embraced capitalism, the American people have been told by our Government and by the press that it is business as usual in Moscow.

I believe that Gorbachev meant exactly what he said. The name of the game is indeed radical reform—radical reform of the Soviet economy, culture, political structure, and foreign policy. Prior to the Moscow summit, Gorbachev's message had gone right over the heads of the American press, the White House, the Congress, and U.S. Sovietologists.

I believe Gorbachev's strategy calls for nothing less than the de-Stalinization of the Soviet Union and includes a direct assault on the centrally planned economy, the inflexible government bureaucracy, the self-serving Communist Party and even the KGB. The Soviets are being driven toward radical reform by a combination of domestic problems and international forces.

They suffer from an inadequate supply of consumer goods and services, rigid political structure, police state mentality, high death rate and an increasingly alienated population. Hungary, China, bilateral trade needs and the Reagan administration's foreign policy have helped draw the Soviets toward radical reform.

All of these forces are quite independent of Gorbachev the man. Contrary to what we are told by American Sovietologists, the Soviet economic reforms will continue with or without Gorbachev. The reforms have a life of their own which predates Gorbachev the man.

Unlike the situation in 1956 when the Soviets resorted to force to snuff out Hungarian initiatives, this time around the Soviets appear to be more interested in emulating some of the more positive aspects of Hungarian economic and political reforms, rather than controlling them.

The fact that China successfully replicated the Hungarian experiment with a population 100 times the size of Hungary in less than one-third the time not only validates the Hungarian experience in the eyes of Soviet leaders, but it enhances its credibility.

In no area are Gorbachev's reforms more radical than in the field of international trade. His objective is to strengthen the Soviet economy and reduce international political tensions through a strategy of increased global interdependence based on bilateral trade between the Soviet Union and the rest of the world. The Soviets must increase the quality and quantity of their exports to the West to be able to finance their much-needed imports of consumer goods, technology, and foodstuffs. Imports break the monopolistic stranglehold some Soviet enterprises possess over certain industries. More imports mean more competition in the domestic market.

Gorbachev learned from the Japanese that the number of nuclear warheads in a nation's arsenal is not nearly such an important measure of international political power as it once was. Economic clout is now more important than military might. Since January 1987, nearly 100 Soviet state-owned enterprises can now trade directly with the West. Foreign companies may own up to 49 percent of the equity in Soviet joint venture companies. Repatriation of profits, reinvestment tax incentives, third-country operations, and expropriation protection are all part of the package. The Soviets have indicated an interest in joining GATT, the World Bank, and the IMF. Special trade zones, new financial and banking institutions, and a possible freely convertible ruble are also in the works.

Corporate giants such as Dow Chemical, Abbott Labs, Pepsico, and Occidental Petroleum have traded with the Soviets for years. More recent entries into the Soviet market include Combustion Engineering, McDonald's, Chevron, Pizza Hut, Baskin-Robbins, Ben & Jerry's Ice Cream, Eastman Kodak, Coca Cola, Johnson & Johnson, RJR Nabisco, and Ford Motor Co.

American companies have been attracted to the Soviet Union by the potential huge market of 280 million people who have one of the highest rates of saving of any country in the world, in part because there has been so little to buy with the extra family savings.

It now appears that it is possible for much smaller American firms such as Merrick Engineering of Nashville, TN, which has 38 employees, to do business in the Soviet Union. My two favorite small American firms operating in Moscow are Lafitte's Landing Louisiana Cajun Restaurant in Baton Rouge, LA, and Delta Catfish of Indianola, MS. What makes the opportunity for American small businesses even more interesting these days is the fact that there are over 30,000 cooperatives in the Soviet Union and an increasing number of small, privately owned businesses in the service sector with whom smaller American companies might trade.

The power of the international marketplace is one of Gorbachev's most important instruments of change. He is much more interested in exporting Soviet-made goods and services, rather than some particular ideology.

If the new chief executive of a major company such as AT&T or IBM wants to introduce fundamental changes, he must come to grips with the company's culture—the attitudes, values, and customs of the firm's managers and employees. This is precisely the situation in which Soviet leader Mikhail Gorbachev finds himself as he attempts to de-Stalinize the Soviet Union and open the closed society. If he is to succeed, he must confront the culture of the largest risk-free society in the world. But that is exactly what he is doing, and he appears to be doing it very effectively.

To increase productivity Gorbachev has offered financial incentives to motivate managers and employees alike. Previously such incentives met with only limited success, since there were no high-quality consumer goods available for which the Soviets could spend their extra rubles. French designers' clothes and other consumer goods imported from the West help energize the reforms.

Which comes first, the production of world-class consumer goods or the use of high-quality consumer goods to encourage the production of improved quality Soviet products? In no sense has Gorbachev completely sorted out this complex problem. However, he has taken some very interesting first steps.

What truly differentiates Gorbachev from previous Soviet leaders as well as most American politicians is the nonconfrontational manner with which he deals with his domestic and foreign adversaries. Unlike some American politicians who subject their enemies to ridicule and intimidation, Gorbachev attempts to co-opt his adversaries through a strategy based on mutual gain.

His subdued response to the downing of Iran Air flight 655 stands in sharp contrast to President Reagan's blustery attempt to turn the 1983 KAL flight 007 tragedy into an international public relations bonanza for the United States. Gorbachev also makes effective use of surprise and suspense to keep his opponents guessing as to the nature of his next move.

The biggest obstacle to Gorbachev's economic reforms and increased U.S.-Soviet trade is not political ideology or government bureaucracy; rather, it is Soviet managers' lack of experience with market-oriented management practices. However, this may be about to change. The Academy of the National Economy will soon unveil a Soviet management education strategy that is second to none. IBM and the business schools at Harvard, MIT and Columbia have helped shape this strategy. As for Marxist-Leninist ideology, it is much more important to some American politicians than it is to Soviet managers.

The two biggest obstacles in the United States to increased U.S.-Soviet trade are American Sovietologists and the U.S. Government.

Even though there is mounting evidence that *perestroika* is here to stay, most Sovietologists continue to cling to the notion that radical reform is impossible and that Gorbachev is doomed to failure. They view each new Gorbachev reform as though it will probably be his last. The possibility of increased U.S.-Soviet trade is considered to be a myth. There is no room in the temple of doom for a Russian optimist with a positive vision of the future for his own country and the rest of the world.

The U.S. Congress and the Reagan administration have created some truly formidable obstacles to increased U.S.-Soviet trade, including export controls, import controls, financial controls, and other political and legal constraints. The Jackson-Vanik amendment linking Soviet Most Favored Nation status to Jewish emigration is a cold war anachronism and should be repealed. The Pentagon's irrational, anti-Soviet technology transfer policies should be replaced by policies based on today's realities, rather than yesterday's myths.

If we mean what we say about wanting to encourage the Soviet Union to become a more open, market-oriented society, then why don't we offer them more positive encouragement, rather than continuing to impose endless Government restrictions on U.S.-Soviet trade and denying them membership in GATT, the World Bank, and the IMF?

If we truly believe in the power of the free market, why don't we give it a chance to work in the Soviet Union?

I believe there are some specific things which our Government might do to facilitate small business trade with the Soviet Union.

One, presently there is very limited professional assistance available to small businesses which want to trade with the Soviets—a handful of lawyers, a few private consultants, and a small staff at the U.S. Commerce Department. I would suggest that the Small Business Administration could play a catalytic role in launching a small business equivalent of the U.S.-U.S.S.R. Trade and Economic Council aimed at smaller American and Soviet businesses, including the new private businesses and cooperatives in the Soviet Union. This would be entirely a private initiative, but the SBA might serve as a catalyst and it won't cost the American taxpayers one cent.

Two, I believe Most Favored Nation status should be granted to the Soviet Union and the rest of Eastern Europe. The Soviets should be given positive encouragement for the progress they have made in the area of human rights.

Three, the Pentagon's irrational technology transfer policies should be replaced.

Four, in general, the Congress should review the whole range of cold war trade restrictions, many of which are no longer in the interest of our country or small businesses.

In summary, *perestroika* offers small American businesses three important benefits: One, new opportunities for trade with a country which has a healthy appetite for American-made goods; two, a chance to recoup some of the high-technology business which was lost to the Japanese and the West Germans as a result of U.S. Government export controls; and, three, a reduction in the risk of war between the two global superpowers.

There may be some unique opportunities for the leaders of small American businesses to increase their profits and contribute to global peace by assuming a stronger leadership role in East-West trade and joint ventures. Rather than resisting global interdependence, we should embrace it. As "Megatrends" author John Naisbitt has said, "If we get sufficiently interlaced economically, we will probably not bomb each other off the face of the planet."

It is not business as usual in Moscow, and it is no longer in our self-interest to continue pretending otherwise.

[Dr. Naylor's statement, with addendum, may be found in the appendix.]

Mr. LANCASTER. Thank you.

My colleague from North Carolina and a colleague of Dr. Naylor's from Duke University, Congressman David Price, snuck away from his Banking markup. I think he would like to make a brief statement and welcome his colleague to Washington.

Mr. PRICE. Thank you, Mr. Chairman.

I apologize for my late arrival and the fact that I am tied up in a markup. Dr. Naylor is a constituent and a friend of mine. I wanted to welcome him to the committee, and I look forward to looking at his testimony. I hope I can be back later in the morning for some of the discussion.

Dr. Naylor is a Professor of Economics at Duke University. He is also a distinguished student of the Soviet system. He has written a book called, "The Gorbachev Strategy," and is preparing a book called, "The Cold War End Game." He is in wide demand across this country as an astute student of Soviet affairs, and as an analyst of what is going on now in the Soviet Union.

We are very fortunate to have him here this morning. I want to add my warm words of welcome. Thank you.

Mr. LANCASTER. Thank you, Mr. Price.

Mr. George.

TESTIMONY OF ARTHUR L. GEORGE, ESQ., BAKER & McKENZIE

Mr. GEORGE. Thank you.

Today, my colleague, Eugene Theroux and myself were to appear before this committee. Ironically, however, Mr. Theroux is in

Moscow today. He was called there on short notice to assist in the negotiation of a joint venture on which we are currently working.

With the permission of the committee, I am pleased to offer our written statement for the record in these hearings.

Mr. LANCASTER. Without objection, the entire statement will be put in the record. You may proceed as you choose.

Mr. GEORGE. The views in our statement and any I may offer today are personal views and are not made on behalf of Baker & McKenzie or any of its clients.

I will summarize the main points in our written statement and respond to any questions which members of the committee may have. My own views are based on extensive travel, study, and living in the Soviet Union over the last 10 years, as well as on more recent business experience with Soviet work at my work. I can say, based on this experience, that fundamental changes have occurred within the Soviet Union, and that they bode well for better economic and political relations between our two countries.

The first point that I wish to make today is that there is now great interest in developing a better trading relationship, both on the Soviet side and from the American business community.

On the United States side, I have witnessed American firms sending representatives in large numbers to conferences on business opportunities in the Soviet Union, and numerous discussions with Soviet enterprises are underway regarding potential joint ventures. In our firm, we have seen a great surge in client interest in doing business in the Soviet Union.

The Soviets are also interested in developing foreign trade. They have instituted numerous reforms in the foreign trade sector. These reforms are basically two-fold. First, the Soviets have restructured the state apparatus for administering the foreign trade sector. Second, they have expanded the opportunities for participating in foreign trade, both for Soviet enterprises and for foreign firms.

In analyzing the opportunities that these reforms present for American small- and medium-sized businesses, it is useful to keep in mind the goals that the Soviets hope to achieve through these reforms. To the extent small- and medium-sized businesses can show they can further these goals, business opportunities will exist for them.

These goals are outlined most concretely in the new joint venture law. There are basically three goals: First, the Soviets wish to increase the availability of manufactured products, foodstuffs, and raw materials in the Soviet Union. In the Soviet Union, increased trade can improve the quality of life for Soviet citizens. Second, the Soviets wish to attract foreign capital, advanced equipment, and technology. Third, they wish to earn and conserve hard currency through increased exports and import substitution.

Business projects that will serve these goals are within the reach of small firms. In particular, such firms can provide consumer goods, food, and services to Soviet consumers. Also, useful technology is frequently developed by small businesses. This would also be of interest to the Soviets.

In summary, therefore, strong interest exists on both sides, and this has created a favorable climate for doing business in the Soviet Union.

Having stated some of the reasons for optimism, my second point today is this must be a cautious optimism. Strong interest in developing business ties in itself is not enough. Business projects must make economic sense. Soviet business partners must be able to make their own business decisions and buy, sell, and invest, not according to whether a state planner says to do so, but when it makes economic sense to do so.

Increased opportunities for American businesses on a broad scale, therefore, will depend on the full implementation of the reforms of *perestroika*. In particular, the Soviets still lack sufficient hard currency to import on a large scale. Business cannot take place on a truly large scale until *perestroika* succeeds in developing efficient enterprises that can export quality goods and earn hard currency.

It is difficult to predict how quickly the reforms of *perestroika* will take hold. The committee, of course, is probably well aware that the Soviet system has been characterized by a large, conservative Party and state bureaucracy, and some elements in this are resisting reforms. In my view, however, responsible officials in the Soviet Union recognize that the old planning system does not work, and that there can be no return to it. The effect of resistance to the reforms may be to slow their full implementation but not to prevent implementation. Therefore, I foresee an expanding field of opportunity for U.S. businesses.

On more specific topics, the first is joint ventures. The major consideration for small- and medium-sized firms here is the high initial costs of negotiating and setting up a joint venture. Such costs will be too high for many firms. Assuming that this hurdle can be overcome, some opportunities do exist to participate in joint ventures. As I have noted, small businesses can provide goods and services in the consumer sector and technology in the industrial sector. This can be accomplished in the joint venture context. Another way to profit from joint ventures would be to supply them, as has been done in China.

Another potential business opportunity I should mention is Soviet cooperatives. *Izvestia* recently reported that, as of July 1 of this year, over 32,000 cooperatives had been registered in the Soviet Union. These are small, privately run enterprises analogous in many ways to American small businesses. The cooperatives are now organizing as associations at the city and regional level. Soviet officials said they expect a national association of cooperatives to be formed before long. Cooperatives may be an important source of business for American firms in the future. As of now, the movement is in its infancy. An efficient infrastructure of transportation and marketing must develop. The Soviets are working hard to develop this. As this network for trade develops, opportunities for business will expand.

My next subject relates to what steps the United States should take to advance business opportunities for U.S. businesses in the Soviet Union. The most principal and fundamental step must be to encourage the reforms of *perestroika* and *glasnost*. One could argue that it is in the U.S. interest to let the Soviet economy fall apart, because the Soviets will become weaker and less of a rival.

However, I don't find this argument convincing. First, if the Soviets fall into dire straits, particularly if this is due in part to negative policies by the United States, Soviet behavior is likely to become desperate, relations with the Soviets will become dangerous, and peace will be threatened.

Second, American policy has been and should continue to be to foster more freedom, more democracy, and market-based economies in other countries, because this preserves peace and furthers the well-being of people worldwide. The Soviets are off to a good start toward these goals.

America should be consistent with its own principles and beliefs, and with its interests, and encourage these reforms.

The example of China is helpful in this regard. U.S. policy has been to promote better economic and political relations with that country. As reforms in China have advanced, the cause of peace has been furthered. The same can happen with the Soviet Union.

The question arises then, how does the continued condition of MFN status on Soviet emigration policies fit within this policy framework? The short answer is that it doesn't. The linkage between better economic relations and emigration is ineffective, even counterproductive, and harms U.S. businesses.

Emigration has risen and fallen according to the overall state of U.S.-Soviet relations, not restrictions in U.S. legislation. I, too, favor a more lenient Soviet policy on emigration. But this goal is better achieved through quiet diplomacy and political pressure than by aggressive, public demands that entail a Soviet loss of face if the demands are met.

On more specific concrete steps, I would suggest having the U.S. Commerce Department or perhaps the Small Business Administration focus on facilitating increased marketing and advertising by U.S. small businesses in the Soviet Union, including participation in trade shows.

The U.S. Government could work first with the Soviet officials, and then ultimately with U.S. businesses and trade associations to provide more information about trade opportunities for U.S. small businesses. These efforts can take place both in the United States and at our Embassy in the Soviet Union.

Those are the points I wanted to cover today. Mr. Theroux and I will again be traveling to the Soviet Union in 2 weeks. The subject matter will again be U.S.S.R. joint ventures. We are arranging to meet with owners of cooperatives and members of cooperative associations during our stay to discuss business opportunities for small- and medium-sized U.S. firms. We believe what we learn from these discussions will be useful to the committee. With the committee's permission, Mr. Theroux and I propose to submit supplemental testimony after your return. If any members of the committee have questions on joint ventures or other topics, I will do my best to answer them.

[Mr. George's and Mr. Theroux's statement, with supplemental views, may be found in the appendix.]

Mr. LANCASTER. Your comments would be welcome. Please submit them.

Mr. LANCASTER. Mr. Bruinsma.

TESTIMONY OF TIM C. BRUINSMA, ESQ., HILL, FARRER & BURRILL

Mr. BRUINSMA. Thank you.

I am here today to report to you about recent developments in matters of Soviet trade. I make my report as a practicing attorney in the field of international business transactions, and as a principal in a Los Angeles-based international trading company, Pacific Intertrade Corp. I am also a member of the International Trade Policy Committee of the California State World Trade Commission. However, I am speaking today on my own behalf as a small businessman and not on behalf of the commission.

My allotted time is quite short, and therefore, my comments will be directly to the point. There are major changes taking place in the Soviet Union today which focus on economic reform. As a result, there is unprecedented potential for trade opportunities with the Soviets as well as improvement in U.S.-Soviet relations. I stress the word "potential" for there are unquestionably significant impediments to establishing normal trade relations with the Soviets. However, to ignore the challenge presented would be a serious error, both economically and politically.

The Soviet Union is undergoing a revolution and the consequences to the world are likely to be profound. The Soviet Union is geographically the largest country in the world, spanning 11 time zones. It has the third largest population—some 284 million people. For over 70 years, since the October revolution in 1917, it has labored under a social, economic, and political system we know as socialism. Like democracy and free enterprise in the United States, socialism in the Soviet Union has been an experiment. But in terms of economic criteria, our system has been an overwhelming success, while Soviet socialism has failed.

Under what appears to be the enlightened leadership of Party Secretary Mikhail Gorbachev, the Soviets have initiated a bold attempt to abandon their self-imposed economic isolationism, to break free from the retarding consequences of socialism, and to enter the modern economic world. In short, the U.S.S.R. is a country in crisis, and it seeks to address its crisis with sweeping reforms. Economically those reforms invite Western businesses to tap a vast new market in return for imparting technology and know-how.

As mentioned, on January 13, 1987, new Soviet laws were enacted which for the first time authorized the formation of joint venture businesses on Soviet soil between Soviet enterprises and Western capitalistic companies. The theory is simple: A Soviet enterprise contributes land, buildings, utilities, natural resources, and labor. The Western company contributes technology, management, marketing, and other free enterprise expertise. The Soviet objectives are two: One, to modernize at an accelerated pace; and two, to generate hard currency, both for priority domestic use and to stimulate the Soviet entry in the world economy.

The American response to *perestroika* should depend upon the answers to two fundamental questions: First, is the Soviet Union sincere and credible in its efforts to enter the world economy?

Second, most germane to our deliberations here today, what opportunities and benefits will flow to U.S. businesses from *perestroika*?

As regards sincerity and credibility, there are positive and convincing signs. To begin with, the Soviets' critical need for *perestroika* is indisputable. The planning and strategy have been intricate and comprehensive, suggesting the level of desperation. There have been major concessions in socialist philosophy, and unthinkable candor and humility. Much of the dogma which the Soviets have developed, defended, and exported for over 70 years has been shed in less than 2 years in an effort to curb the country's economic decline. There are clear examples of this process. They fall into at least three basic categories: Economic actions, political actions, and social actions. Some of these have been touched on, and I won't repeat them all.

Economically, I think you are aware that the Soviets are trying to get into GATT and the World Bank. They also seek Most Favored Nation status with the United States.

They are exploring a variety of solutions to the ruble, and despite Western skepticism, they are optimistic that convertibility will be achieved in the short term.

Internally, ministries are being dismantled, reorganized, and reoriented to implement the novel outward approach to dealing with capitalistic nations. Many lower level enterprises are now authorized to deal directly with the West. Of course, the best example of this is the joint venture program.

Politically, the changes are impressing even the most ardent cynics. For example, Gorbachev's own book, "*Perestroika*," published for worldwide consumption, which is a study in national humility and self-effacement, surprising Soviet restraint in the Persian Gulf, in the face of our substantial U.S. naval presence there, punctual withdrawal from Afghanistan, and Gorbachev's recent offer to withdraw forces from the Soviet naval base in Vietnam if the United States would do the same in the Philippines.

Within the Soviet Union, the change in attitude is equally dramatic. The sins of Stalin are being exposed and condemned, and the philosophy of Lenin is being reviewed and clarified, consistent with present goals. It is almost amusing to read the front page of Pravda where you see a reinterpretation of what Lenin said. Some Soviet friends are even saying that, "Mr. Lenin was truly a capitalist underneath. We can see it in his writings if we look hard enough."

Soviet textbooks are being rewritten to reflect history from a more objective perspective. Publications such as Pravda and Izvestia are printing opinions of citizens and journalists alike, which are critical of government policies.

There is now talk of a two-party political system, and political demonstrations within Moscow as well as the Republics are being tolerated.

The list of changes and events goes on and on, as indicated in our newspaper reports every day, all suggesting that the Soviet government is truly committed to accomplishing *perestroika*.

But even if the Soviets are becoming better world citizens, what about the second question presented: What does all of this mean to United States business?

The opportunity presented for U.S. companies is to reach a heretofore impenetrable market of vast proportions, possibly to the exclusion of competition, at least in the short term. The concept is appealing and logical enough, but the execution is difficult.

The first major deterrent to most Western businesses is the basic problem of accomplishing anything in the Soviet Union where free enterprise attitudes, services, and experience are sorely lacking. The process is laborious, often frustrating, and, as a result, expensive.

The second and much discussed deterrent is the problem of reaping benefits in hard or convertible currency. The American executive is generally willing to assume the risk of profitability. He will weigh all factors and trust his judgment. He has entered markets throughout the world, under all types of circumstances, and he has succeeded. But, if after meeting all of the challenges of doing business in the U.S.S.R., if after the joint venture actually manages to make a profit, he must then still face the problem of not being able to repatriate his earnings in hard currency, he may decide that his investment dollars are better spent elsewhere.

While some companies are turning back in the fact of this and other problems embedded in the joint venture laws, scores are moving ahead, many quickly, to penetrate the new Soviet market. Today, the interest level is high, due in no small part to the impressive public relations efforts which the Soviets have instituted. They have put out the welcome mat to U.S. businesses in particular. In some cases, they have sent delegations here, not just to target particular industries, but specific companies producing products which are in greatest demand in the floundering Soviet economy.

There are presently many companies at various stages of Soviet trade negotiations. I, myself, currently represent companies in such diverse fields as breakfast cereals, toys, communications, education and children's books, real estate development, oil drilling equipment, gymnasium equipment, and clothing, and aseptic food processing equipment. These clients range in size from the Fortune 500 to startups. The common denominator is their appreciation of the rare opportunity to enter the immense new Soviet marketplace.

There are natural advantages which larger companies have over small businesses, the most obvious being the resources to pursue opportunities in a difficult region like the Soviet Union. But the unique features of this marketplace are also proving particularly beneficial to small businesses. For example, since the Soviets have a controlled, centralized economy, it is not only possible but probable that certain monopolies will exist for some time until a mixed economy can develop.

Monopolies may exist either by industry, by product, or by region, or all of the foregoing. As a result, the Soviet focus in many cases is on a particular product or technology of a U.S. company, not its resources to manufacture or market it. The Soviets themselves have the basic resources and can control the internal market. Thus, if the technology is one which they want badly enough, many of the impediments to developing the means of reproduction and penetrating the marketplace can be eliminated, including any shortage of capital.

The result is a leveling effect as between large and small businesses. Of course, the joint venture vehicle itself provides an easy solution to this problem, since the percentage interest of the smaller U.S. partner can merely be reduced to reflect its more modest capital participation.

It is quite conceivable, therefore, that the same pattern which we see in the United States, where small businesses far exceed large businesses in their share of innovation and national production output, will be evidenced in the development of Soviet-American trade in the era of *perestroika*.

Certainly, the cost of initial negotiations with the Soviets may be a matter of concern for the small businessman, for at this stage he is competing with big business for Soviet attention, but thereafter, he may find his disadvantage to lessen. Obviously, the larger corporation will also be better able to endure financially if the purpose is to manufacture a product which requires a large capital investment or a protracted period of time to bring to market. But many products and services are not so capital intensive, and it is the know-how which is most attractive to the Soviets.

Many of us are addressing the ruble convertibility problem, and we are finding solutions which lessen, if not neutralize, the concern. Such solutions range from new forms of countertrade, to Soviet State Bank guarantees, to creative financing arrangements with Western banks. The Soviet answer to the problem is to require the joint venture to export product to generate hard currency abroad which will be used to fund the distributions to the Western partner. This is a good theory but, in many cases, it is unrealistic, at least until the joint venture is well established and can deal with its domestic marketing requirements.

The export issue suggests one of the most important observations to be made for the small business considering entry to the Soviet market by means of a joint venture.

The Soviets have carefully designed the joint venture model and are attempting to force every product or service to fit within the prescribed structure. Yet, all products and services are unique, and they are not all readily susceptible to the joint venture approach. In addition, the Soviets generally lack the practical experience and creativity of a free market, and arguably do not fully understand, themselves, how their joint ventures will work. Thus, despite the fact that the Soviets appear intractable in their determination, their need to modernize and to make *perestroika* work is so compelling that flexibility will unquestionably be necessary. Therefore, a U.S. business should not accept the joint venture requirements at face value without carefully understanding their ramifications, and it should insist upon modification where necessary.

Let me give specific examples of the products and problems we are encountering right now, from my own experience. I think each is illustrative of some of the main subjects touched on by my colleagues and myself.

The first example is dry breakfast cereals. A major U.S. company, a client of mine, will actually be creating a market for its product. There is not at this time a great amount of consumer demand for dry breakfast cereals with cold milk in the Soviet Union because the custom apparently has not developed there. Thus, the company has a real challenge to create a new market. Yet, if it creates the market and forms a joint venture, it may end up with a virtual monopoly.

The company has found a Soviet partner with an entrepreneur, a gentleman who reflects a more Western work ethic, in Riga. He is ready to cooperate with them. Apparently, he wants to make a dollar, and that is what he intends to do. I think the point to be emphasized is that what goes on in Moscow among the Russians isn't necessarily what is going on up in Riga.

Similarly, this client has negotiated some very interesting incentives for employees. Surprisingly, quite contrary to the typical stereotype of the Soviet worker, the Soviets love the idea of incentives. We are finding a tremendous amount of interest in high productivity in response to incentives; things like Western goods, pop records, and other things of that sort, which wouldn't make their way into their hands.

A second client matter concerns toys. Our client's seek a joint venture for manufacturing toys. This project happens to be in Riga again. This is possibly an example of a perfect product for joint venturing. The toy in question uses materials available in the Soviet Union. It is not highly technical. It can be exported into Western markets to generate hard currency to pay the Western party.

The issue we are dealing with here is our client's reluctance to wait for the longer term hard currency without a hard currency commitment up front. At this time we are negotiating with Western banks to see if we can provide it in debt financing.

A third example is aseptic food processing equipment. There is a company in California that manufactures a food processing facility on wheels. It is a 40-foot tractor trailer which can drive into the fields. Essentially, you throw tomatoes in one end and they come out packaged for transport and sale at the other end.

That project has been given top domestic priority by the Soviets. They have a 50-percent spoilage rate in their agricultural production. Anything that doesn't spoil on its way to Moscow is interrupted by the locals who would rather consume it themselves than send it to the city.

Unfortunately, there is no export market for the unit. There is a good and a bad side to this. The good side is that there would be no self-competition by the American company if the Soviet joint venture exported to other markets because this product isn't sold anyplace else in the world. It is not sold anyplace else in the world because it is not economical.

But to give you an example of how you have to adjust to the Soviet mentality, I sat at a meeting in Moscow with a small business client and Soviet officials. My client explained to the Soviets why this unit was too small for their purposes, not economical, and he therefore didn't think it would work for them. I said to him, "It doesn't matter in a command economy whether it is economically feasible; this is a product their economy needs." The Soviets said in no uncertain terms that this technology would revolutionize their food distribution system. So, this project illustrates the fact that even if there is a product that will not be suitable for export, if the Soviets need it, they will find some other way to divert hard currency to acquire the technology.

One other thing this project illustrates is the size of this market we are talking about. The Soviets wanted to start by experimenting with the product. They wanted to have some test units to start out with. These units sell for about $500,000 a piece, and they wanted an initial startup quantity of 1,000 of them!

A fourth example is a company manufacturing auger drill bits. A manufacturing joint venture could draw on local materials. There is an excellent domestic market, and the Soviets need this technology. But here we have that problem of self-competition which was mentioned. The company is presently in every major Western market. The last thing it wants is to export and compete with itself.

I might contrast this with the toy situation. The toy company is a U.S.-based company, but they no longer manufacture a single toy in the United States. Therefore, they could manufacture in the U.S.S.R. as well as other places. Those of you who might be concerned about U.S. companies exporting jobs by starting Soviet joint ventures can also see by this example that there would be no exporting of jobs. The jobs are already gone.

They are in the Philippines and other parts of the world. In fact, we were negotiating with the Soviets on this particular matter, and the president of the company told the Soviets in no uncertain terms, "If you can manufacture a high quality, cost-competitive product, we will shut down our facility in Portugal, in Spain, in the PRC." This certainly caught their attention, the thought of the Soviets taking business away from the PRC! It was a very interesting discussion.

Quickly, let me mention a few other projects. One is educational children's books, pursued by a small business which is practically a startup company. Yet, they are going to put together a joint venture to manufacture a particular type of teaching procedure in children's educational books to be adopted by the Soviet school system. This is an opportunity for American education to have a tremendous impact on the Soviet system. Next, turn to computers. There is a computer company that is doing a joint venture. The company is manufacturing computer parts and sending them to the Soviet Union, and the Soviets are assembling them.

The project incorporates counter trade, and is an example of one way to deal with the currency problem. The U.S. partner will be taking out software manufactured by the Soviets, which is superior to our own, and marketing it in the West.

Finally, let me give you an indication as to two projects which I believe are likely to be a success. Charter bus service is one. There may be a charter bus joint venture with Intourist. Then, when a Westerner goes to Moscow and wants to go on a tour to Leningrad or elsewhere, for example, he could do it on a joint venture bus line that involves a Western company, and 90 percent of the revenue of this venture would be hard currency since the passengers will all be Westerners.

The last example is the new Moscow Hilton. Yes; I believe there will be a Moscow Hilton, and it will generate 100 percent hard currency. I guarantee every one of you, if you go there, will want to stay in it because there are not many good hotels in Moscow. These projects will work well.

Obviously, the Moscow Hilton represents big business. But think of the numerous services that small businesses can contribute to the project, and you realize that it represents an opportunity for small business as well.

Let me draw to a conclusion by saying there may be some understandable reluctance to trade with the Soviets for political reasons or because joint ventures may appear to result in the export of jobs rather than products and services. I submit these arguments are not persuasive in light of the real progress we are witnessing in the Soviets' efforts to become better world citizens.

I think we should be optimistic and encourage this activity. Let me give you an anecdote that came out in San Francisco at a program I was moderating in Soviet American trade. The senior vice president of Apple Computers was talking about a high level management delegation that went to Moscow. Apple had been in Moscow for 4 or 5 years. When this delegation of executives prepared to go there, they planned to take with them a few of the new state-of-the-art McIntosh computers for demonstration purposes. When they went through the normal export licensing process, everything was cleared except for one component, called the hypercard, an embedded language component. They couldn't get an export license for that part of these demonstration units.

Nevertheless, when they got to Moscow they set up a unit and one of the Soviet technicians began to operate and demonstrate it. Suddenly, he stopped and looked back at the Americans and said, "Where is the hypercard?" The Apple official said, "Well, we have export regulations, restrictions, and we couldn't bring it." The technician said, "No matter, I have one in my office." And he ran out to his office and soon returned with one.

The point this illustrates is that we are kidding ourselves if we think that by our export restrictions here in the United States we are stopping this type of technology from getting there. In fact, we are competing with others who are already there ahead of us. Estimates are that 75 percent of the new business activity in Moscow is Japanese.

The conclusion to be drawn from all this is that something very important is happening in the Soviet Union and it may translate into unprecedented trade opportunities for alert and visionary U.S. companies. It is my strong belief and recommendation that the Congress should monitor trade events in the Soviet Union carefully and develop a policy to support U.S. businesses, especially small businesses, wishing to explore the Soviet marketplace. American businesses are not alone in observing the developments. We are, in fact, reacting less aggressively than others such as the Germans and Japanese. Yet, there is a special reason for the Soviets to deal with Americans, and for us to deal with them. As the two most powerful nations on earth, locked in a perpetual ideological struggle, the Soviet Union and the United States have a responsibility to the rest of the world to explore every opportunity to substitute conciliation for confrontation. Communication is essential to the process. By beginning to dismantle our trade barriers, we may begin to develop a new, constructive relationship and with it a renewed hope for a lasting peace. Thank you.

[Mr. Bruinsma's statement may be found in the appendix.]

Mr. LANCASTER. Thank you. All of the statements were excellent. I look forward to the discussion which will follow.

Mr. Bilbray, do you have some questions you would like to ask at this time?

Mr. BILBRAY. No; I don't.

Mr. LANCASTER. Mr. Sisisky.

Mr. SISISKY. I would like to extend my thanks for a very fine presentation. I must tell the last speaker that I can understand Apple's point of view. I have been friends with the chairman of the board of Apple, who was instrumental in helping PepsiCo, a company of which I am familiar.

So, I can understand why Apple was indeed interested. Dr. Naylor, you said if Gorbachev goes, it wouldn't make any difference. I am not satisfied that is true yet.

The reason I came to this meeting was my interest in this issue but, I, for one, am not ready to transfer the technology, even though I know that the Germans and Japanese have been transferring technology for a good number of years, along with bank credits, which is probably more significant than anything else, and that has not been mentioned.

I think we are struggling right now. I was in the Soviet Union in 1985. I went with Speaker O'Neill, and that was after Mr. Gorbachev came into office. We delivered the first letter from the President to try to set up the first meeting.

I remember taking a walk, and, as you know, the Soviets like to talk for obvious reasons where there are no microphones. They seem to talk a lot more when they are not in a room. I was talking about my experience in a machine tool factory. They were 4.5 years behind in deliveries. When I asked the question, "How many shifts do you work?" They replied, "One shift."

I said, from a businessman's perspective, why don't you add another shift? They can't get the people. Obviously, I said, "You are going to have to give an incentive to get people." I remember the remark coming back, "That would be the end of socialism to a degree."

Now, how do we bridge that gap with incentives? I am talking about real incentives for marketing. They can have all the cooperatives they want, but, obviously, marketing skills need to be developed, not only in the Soviet Union, but also overseas. Dr. Naylor, how do you really visualize making true socialism and true incentives work together to encourage people to produce and to work harder? Is there some formula that you visualize?

Dr. NAYLOR. I will give you an example. During my last trip to Moscow, there was an announcement in one of the local daily newspapers that the first private American management consulting firm had opened in Moscow. For the remainder of my stay in

Moscow, every economist I met sought my advice on how to start a private management consulting firm. Even though private consulting had only been legalized 3 weeks earlier, the entrepreneurial juices of these Soviet economists were already flowing.

Mr. SISISKY. Who would own the firms?

Dr. NAYLOR. They are privately owned.

Mr. SISISKY. By Soviet citizens?

Dr. NAYLOR. Yes; they may either be private cooperatives or private family-owned businesses.

Mr. SISISKY. How do we treat the profits coming from this, and joint ventures with foreign firms? Can you transfer the profits into another country?

Dr. NAYLOR. Profits can be taken out in so-called hard currencies only if they have been earned from exports. Otherwise, they must be retained in the Soviet Union. Some American firms use their ruble profits to buy Soviet-made goods which can be exported to the West for hard currency.

Mr. LANCASTER. Mr. George, would you like to comment on that?

Mr. GEORGE. Yes; just on the hard currency transfer problem. Article 32 of the joint venture law guarantees the right to repatriate profits. They are taxed on that 20 percent, in addition to the normal Soviet tax, but if there is a tax treaty, a double taxation treaty which negatives that tax, which exists in some countries, then you don't have to pay it.

However, article 25 of the joint venture law says that hard currency must come from revenues of sales abroad. So, that is the catch-22. You have to earn the hard currency, and you can do that through exportation. You can do it through countertrade arrangements. The Combustion Engineering joint venture is one where Combustion will get profits in petroleum products, which they will turn around and sell abroad for hard currency.

In the area of services and food, like restaurants, there are a number of arrangements, like with Pizza Hut, where you can set up two locations, one for hard currency, one for rubles, and earn the hard currency profits and transfer those out.

Under a revision in the Soviet joint venture law, joint ventures now have the right to buy and sell on the Soviet market for either hard currency or rubles. So, it is possible, for instance, if a joint venture can produce a product which was previously imported, say, at a lower price, it may be more attractive for a Soviet enterprise to buy from the joint venture than to import, and I think it is possible to state a price, say, of 100, partly in rubles and partly in, say, dollars, and the hard currency amount of the price need only be enough to cover profit.

So, there are a lot of different arrangements that can be reached.

Mr. SISISKY. It is still not simple, but I assume the different arrangements are evolving.

Mr. GEORGE. People like us are being real imaginative in trying to get around the fundamental problem, which will never be solved until the ruble becomes convertible. Even the most optimistic estimates that I have seen date that some time in the mid-1990's. That is optimistic.

Mr. SISISKY. I think we have to go vote.

Mr. **Lancaster**. We will stand in recess for a few moments so that we can go vote on the defense spending conference report. We will be back for additional questions, if you will stand by.

[Recess.]

Mr. **Lancaster**. If we can take our seats and resume our discussion.

First of all, I did see the chairman, Mr. LaFalce, on that vote, and he indicated that it is unlikely that he will be able to return because of legislation that he has a significant personal interest in being considered by the Banking Committee, on which he is a very senior member. He wanted me to pass on to you his thanks for your being here and his regrets that he is unable to be present to preside.

This is a question for all three of you. Of course, there is significant change in the area of the Soviet Union, the General Secretary stated last week that economic reform is at a critical stage. We noted that the meetings are going on perhaps at this very hour still in Moscow. I wonder if each of you would care to comment on what you feel is the greatest challenge Mr. Gorbachev will face and what have been his greatest successes thus far?

We will, again, start in the same order in which you originally testified.

Dr. **Naylor**. I believe that Gorbachev's two greatest challenges are the lack of convertibility of the ruble and also the inexperience of Soviet managers in market-oriented management practices.

All of the rules of the game have been turned topsy-turvy in a very short period of time. The new enterprise law only went into effect January 1, 1988. Cooperatives and private service businesses only became legal in May 1987. Soviet managers have no experience or background in dealing with such institutions.

A lot has been said in the last 3 months by the press and by American Sovietologists about shortages of consumer goods in the Soviet Union. Why is this so surprising? The new enterprise law has only been in place 9 months and the law on cooperatives was only enacted last spring.

Only in America is instant gratification such an established way of life that we expect a quick fix for everything. The Soviets have waited over 70 years for improved consumer goods. They can probably wait a little longer.

Mr. **Lancaster**. Mr. George.

Mr. **George**. I would say the main achievement is that *glasnost* appears to be working, and that is important, because the free flow of information and free discussion is really essential to *perestroika*. As far as *perestroika* is concerned, it is of fundamental importance that what we are talking about is not mere policy.

Gorbachev has succeeded in putting these policies into law. There is a new law on state enterprises and a new law on cooperatives. There is a new law for joint ventures. So, the legal basis has been established, and now it is a matter of, in these areas at least, implementing these changes. That is where the challenge really comes now.

What he faces is an entrenched party bureaucracy and state bureaucracy, and many of these people feel personally threatened by the changes. We had this Party conference this past summer, and you could see these delegates sitting in the room there and hearing these speeches, and you can just see them sitting there and thinking, "Well, what is that proposal going to do to me?" That is the way they are viewing it, and so, more people have to see that it is in their own interests for these reforms to go forward.

The other challenge he faces is inexperience, both in terms of the government officials facing new responsibilities and also inexperience among Soviet enterprises, because, although they are very eager to learn how to do business, they don't have a lot of experience. So, it is going to take some time for them to develop the expertise needed to operate successfully.

Mr. **Bruinsma**. I think probably the greatest achievement on a major level is the understanding of the Soviet predicament and, of course, the development of *perestroika*, in particular, the rapid establishment of a legal basis for proceeding with *perestroika*. I think that the greatest challenges break down into the internal and the external.

Internally, there is apparently impatience; that is, a growing impatience with the slow development of *perestroika*. I personally think, however, that this is less likely to be what is actually going on in the Soviet Union than the way the West is perceiving it. This, I think, leads Gorbachev's external challenge. I think that the West, and I would include the United States in this to a certain extent, is trying to undermine him a bit by saying "We told him so," that he couldn't do it, before the reforms have even had the chance to develop.

The Soviets have been patient for 70 years, and they haven't gotten very far in many areas. In fact, their national personality seems to be basically one of patience and simply wanting to be left alone.

Obviously, as a practical business matter, the ruble problem will continue to be the greatest challenge, and on the broadest level, the biggest challenge is to create an infrastructure within this country that will support a mixed economy, because *perestroika* cannot happen without that infrastructure. In this country, if as a businessman, you want to go from A to B, you know how to get there, and you call upon a service, or a person, and there is always a product to do it. In the Soviet Union, there is a gap there. It just doesn't happen. That is where the small business will come in, because it can begin to develop this infrastructure the same way it developed in this country.

Mr. **Lancaster**. Dr. Naylor and also Mr. Bruinsma mention the problem of ruble convertibility. The timetable that Mr. Gorbachev set for himself for price reform, in my opinion, is certainly a first step toward convertibility of the ruble with convertibility only within socialist bloc countries by 1993.

First of all, is this a realistic timetable? Is it too fast or too slow from their perspective?

Second, from a trade perspective is it not significantly too slow? We are patient, as you have indicated, in this country, but will American businesses wait that long for the necessary reforms, particularly, if they are going to realize any profit in their ventures. Would you both comment on that.

Dr. NAYLOR. Price reform is a necessary prerequisite to the convertible ruble. Gorbachev is doing a good job of educating the Soviet people about the necessity and likely consequences of price reform. Given the political realities of the Soviet Union the timeframe seems reasonable.

My colleagues have already suggested some clever ways around the ruble convertibility problem.

A small American businessman who recently contacted me plans to establish a bank in the Soviet Union to work with small American firms helping them convert their rubles into commodities which could then be converted into hard currency. Entrepreneurs all over the world are being attracted to the exciting new environment in the Soviet Union.

So, I think there are entrepreneurs from all around the world seeing opportunities in what appears to be a problem and it is a problem, as everyone points out.

Mr. BRUINSMA. I would like to respond by saying I think it is not likely that there will be full convertibility within the timeframe the Soviets are telling us. But that won't necessarily slow us down.

If you look at the currency situation, you see it is a very disjointed type of problem. You are paying $1.65 for a ruble in Moscow. You walk outside on the street and you can get four of them for $1.00.

I can even tell you that if you want to walk into Union Bank, downtown Los Angeles, they will give you 14 cents on any good day for any rubles you have in your pocket.

You can find a price for a ruble anyplace you want, and it seems to me that until the Soviet system stabilizes in this area, convertibility is a little unrealistic. That is the bad news from our standpoint, but the good news, I think, is that, as I tried to emphasize, I don't think you have to accept the entire joint venture law on its face.

It is becoming almost hypothetical. The game plan in the coming months is going to be in the cooperatives area. I think that joint ventures will continue to prove to be either unrealistic in too many ways or else only suited for particular types of projects.

As a practicing lawyer, for example, I and others have addressed the problem on three or four different practical levels. We are making progress. One example of this is when the Soviets want you to put technology into the joint venture. You don't simply give it to them, you license it to them; you ask them for hard currency payments from day one.

A second example is when they push this concept of exporting at you, you tell them, "Fine, what do you know about marketing?" and they sit there with a blank stare on their faces. They have never had to market. To solve the problem, you set up a company that is a marketing corporation that takes a commission of, for example, 10 percent of whatever the joint venture can sell in the West. It gets paid in currency on its way back to the joint venture.

Any joint venture that will manufacture needs components. For example, take toys; there, it needs molds which have to be made someplace. If it is going to try to commence operations in the short term, it is going to have to buy existing equipment.

It is going to have to pay hard currency. So, going in, the Western partner must say "Here is the deal; we will put in this, that, and the next thing, but the venture will have to buy components." Similarly, in the case of supplies and other types of materials, until things get going, there has to be a sale by you to the venture, and you will want to take hard currency. The Soviets can find the hard currency if it is important enough to them. In such cases, I think you are going to see that hard currency will come one way or another.

Perhaps one last comment is appropriate to follow up on the comment about stocks and bonds. When I was at the Trade Council meeting in Moscow in April, I was having breakfast with a gentleman who introduced himself as general counsel to a major U.S. brokerage firm. I asked him what an investment banking firm or stock brokerage firm was doing there, and he said they were there to create the new Moscow stock exchange. Again, Gorbachev hasn't missed a trick. *Perestroika* is a well contrived, strategized program and it is happening at all different levels.

Mr. LANCASTER. At a recent party conference and repeatedly in the press we hear that the Soviet Union is particularly interested in placing emphasis on food, health, and housing among other issues. Do you have any information, any one of the three of you or all three of you, as to what their priorities are going to be, and do you believe that consumables are the greatest area in which small business might involve themselves in the Soviet market? If so, which of those are most likely to prove profitable and workable?

Dr. NAYLOR. The broad categories include consumer goods, technology, and food stuffs.

Mr. GEORGE. I would agree. I would say food, and particularly food processing and distribution, is of crucial importance to the Soviets right now. As Mr. Bruinsma had already mentioned, a large part of the problem is not that they don't grow the food, it is getting it to market. A lot of food spoils, and so they are putting particular emphasis on that, and a lot of the new projects that have developed recently have to do with food processing and distribution.

So, I would say that is probably one of the best opportunities right now. Medical equipment is another big area, and chemicals.

Mr. BRUINSMA. I don't think there is any question it would be food. I think it serves the political need right now. If you talk to the typical Soviet on the street today in Moscow, there is still a certain pessimism about what is happening. He thinks Gorbachev is one more person who is going to come and go like Khrushchev. He will say to me, "You know, there is all this talk about joint ventures and making everything better, but when I can get milk and bread on a regular basis and good meat, then I will understand what *perestroika* is and see it working." I think food is where it is going to happen.

The Soviets must try to get broader support from the people in this way.

Mr. LANCASTER. Of course, my district is a very rural district, a very agricultural district, producing more turkeys than any other in the country. We produce a lot of poultry in general and a lot of hogs, and I know that is an area of great shortage.

We hear about exporting grain to the Soviet Union, but is there going to be a short term market for food stuffs other than to feed their animals and to make bread? Is there a market there for poultry and hogs and for foods that are not traditionally, up to this point, exported to the Soviet Union?

Mr. GEORGE. There is the old story that if you give a fellow a fish, you have fed him for a day, but if you teach him how to fish, you feed him for life. That applies equally, I think, to the Soviet Union. I don't think there is a great market for just selling finished food products. There is always going to be some, but what they are most interested in is getting the means to grow the food and get it to market.

Mr. BRUINSMA. I am pleased to say that the California raisin growers and almond growers have been enjoying a very healthy business with the Soviets now for some time and their trade is in the millions of dollars.

Dr. NAYLOR. North Carolina turkey farmers are talking to the Soviets.

Mr. LANCASTER. Each of you have mentioned ways in which the Government might be involved in facilitating small business trade, but if you would, give us your priorities of where you think Congress should act first in taking legislative action to facilitate trade with the Soviet Union, with particular emphasis on the small business angle.

Dr. NAYLOR. The SBA could quite easily play a catalytic role in starting a private organization like the U.S.-U.S.S.R. Trade and Economic Council to work with small businesses.

The U.S.-U.S.S.R. Trade and Economic Council does an admirable job of supporting Fortune 500 like companies, but there is no comparable organization to support small businesses. Such an organization might be financed initially by private foundations and would not require Government funds.

Mr. GEORGE. I mentioned during my statement that I believe that it would really help for the Soviets to be granted MFN status. That is a legislative measure.

Mr. LANCASTER. Let me interrupt you. Do you think it would be particularly helpful in developing small business trade with the Soviet Union if, perhaps, the Jackson-Vanik were repealed as to small business but not generally, as an incentive to small business?

Mr. GEORGE. There may be some benefit, I think, in the short run. There might also be an exemption for products imported from the Soviet Union by joint ventures. Ultimately, though, it could result in keeping the rest of Jackson-Vanik on the books longer, and so in the long run it may—granting such exemptions could work the other way and be counterproductive. It would probably send a better signal just to repeal the whole thing.

In terms of other concrete measures, I mentioned in my statement setting up the exchange of information between the two governments. I think this is an inter-governmental process, as well as a process between private businesses.

The Soviets, and in particular cooperatives, just don't know how to deal with the U.S. firms or other foreign firms. They want to buy things but they don't know where to go. Likewise, many U.S. small businesses have difficulty in learning what the Soviets are interested in buying. So, setting up some kind of exchange of information through the SBA or the Commerce Department, U.S. Embassy, could be helpful. Also, and this was mentioned in the long statement that we submitted, some kind of educational exchange, I think, would ultimately be beneficial to both countries.

We mentioned in our statement that there are about 30,000 Chinese students here in the United States right now learning business, law, and engineering. Although, in technical areas, there may be some restrictions on doing this with the Soviets, I think that would lead to a lot more sharing of information and develop the business climate in many beneficial ways, as it has done in China. Thank you.

Mr. BRUINSMA. First to follow up on what Mr. George just said. The Department of Commerce has just established a relationship with the Soviets which is a form of educational exchange, whereby we will now maintain a trade library at the Department of Commerce, and the Soviets are doing the same thing in Moscow. This should be a breakthrough, enabling small businesses to go to the Department of Commerce and take advantage of this library.

Also, there is a Department of Commerce office in Moscow where you can go as a small businessman, and you will find full services to assist you when you are operating in Moscow.

Let me address your question directly with these three points:

The first thing Congress can do is to foster and project an attitude of positive, normalized trade, thereby creating a good trade environment. I think this can be implemented by MFN status.

Second—and I don't mean this too harshly—but simply stated, Congress can "get out of the way." I believe in, and I have great confidence in U.S. business. I think we can make it on our own. But we don't want to be restricted. The trade restrictions right now, the unnecessary redtape, sometimes make export trade difficult.

Again, we are seeing progress, however, with the new export office on the west coast, which is a tremendous thing for all of us on the west coast.

Finally, and very concretely, I think an export finance program would be very much in order. We now have a California Export Finance Board which supports exports with low interest loans and grants. I think this type of program can be adopted on a nationwide basis and can be useful to companies targeting the Soviet marketplace as well as others. There are no restrictions in California on using this program for Soviet trade, and I think a small business that goes into our California Export Finance Board and asks for a financing package to go ahead and explore a Soviet marketplace is doing something positive for itself, for the state, and for the United States.

Mr. LANCASTER. Dr. Naylor, you will recall that Mr. Sisisky questioned you with regard to your statement that Soviet reforms would continue even if Gorbachev were removed. I wonder if you would comment on that a little more fully?

Dr. NAYLOR. The reasons underlining the reforms predate Gorbachev and are independent of him. They now have a life of their own and will survive even if Gorbachev does not. I was in Moscow in 1982, working with a group of 250 Soviet economists who were conducting computer simulation experiments of virtually all of the reforms now being implemented under the label of *perestroika* in the Soviet Union.

There was a complete understanding by all Soviet economists that fine tuning or patching the Soviet economic system was not one of their options, and the only way to fix the Soviet economy was with radical reform.

All of that took place 3 years before Gorbachev became the General Secretary. Radical reform was being widely discussed by the most important Soviet economists long before March 11, 1985.

There are some unique things which Gorbachev brings to the table, including the way he deals with adversaries, his frontal assault on the Soviet culture, and his psychological sophistication. Khrushchev and Brezhnev, tried unsuccessfully to change the economic mechanism of the Soviet Union and failed. They went about it as though they were being advised by a bunch of technocratic economists who knew nothing about human behavior.

Gorbachev employs a multidimensional approach in which he simultaneously confronts the Soviet culture, political system, foreign policy, and economic system.

Mr. LANCASTER. On page 7 of your statement, you go into an area that was also of concern to Mr. Sisisky, and that is transfer technology that is being impeded by the Defense Department. You state in your written statement, but I don't believe you went into it in your oral statement, that those controls may have, in fact, inadvertently strengthened the hand of the Russians technologically. If you would perhaps clarify and expand a little bit on that statement?

Dr. NAYLOR. I think the Reagan administration singlehandedly created a new cottage industry throughout the Soviet Union and Eastern Europe—private manufacturers of clones of American microcomputers which appear on the Pentagon's export control list. I have visited many of these businesses in Warsaw and in Budapest, and they are quite amazing.

In Warsaw, small private businesses are thriving, producing clones of IBM, Apple, and other American computers. The incentives are clear. Since American computers sell for five or six times the usual American price in Warsaw, you can make a substantial profit in this business. There would be no such industry if it were not for our irrational export control policies. In some cases the Soviets have used market signals from the Pentagon to help them decide which technologies are really worth pursuing.

Mr. LANCASTER. You have also stated in your written statement there is a very high savings in the Soviet Union, but yet they have chronic problems of capital. Explain that result. How can you have a high level of savings but not have capital? Are they putting it away in the mattress, or in their sock, or just what is the situation?

Dr. NAYLOR. Until very recently the only source of financing for Soviet firms was Gosbank. The Soviets are now creating the same kind of financial institutions the Hungarians and Chinese have developed in the last 5 to 10 years. New mechanisms will be available to convert savings into investment capital.

Mr. **Lancaster**. So, it really is a mechanism problem that will solve itself very quickly, and capital will begin flowing into production rather than sitting idle?

Dr. **Naylor**. Yes; in the 1990's, managers of Soviet enterprises will have access to a variety of alternative sources of capital, including Gosbank, development banks, possible joint ventures, as well as domestic and private foreign sources.

So, being chief finance officer of a Soviet business is going to become a real job in the future.

Mr. **Lancaster**. Mr. Bruinsma, from a very practical standpoint, you bring a wealth of information from your experience not only as a business person, but also as an attorney representing and advising other businesses in how they might become involved in Soviet trade. I wonder if you would give us a shorthand outline of what small businesses can and should do to become involved in Soviet trade?

Mr. **Bruinsma**. I would be glad to.

I would like to make it clear this is a new game for all of us. The term of my interest has only been about 2½ years. In that time I have synthesized a lot of information. There are people who have been doing Soviet trade for years and years, but I think I can give you some concrete examples.

The first thing that a company can do is to join the U.S.-U.S.S.R. Economic Trade and Economic Council. It is expensive, but they have offices in New York and Moscow, and they certainly can put you in touch with some of the better contacts that you need to do business there.

Second, there are numerous trade and industry organizations these days that are putting Moscow on their itinerary. In your own industry, you can probably find a trip that is going to take place or the opportunity to create one.

Third, there are Soviet trade companies around the United States. For a commission, or on some other financial arrangement, they will work with you.

Or, you can go to a consultant. There are people doing this type of work on a consulting basis. In essence, that is what I am doing as an attorney, although in my case I probably emphasize a little bit more the structural part of putting the business venture together. But I think you have to be fairly comprehensive in representing a small business in this arena, so I try to help with both the business and the legal part of the representation.

You can actually go to the Soviet Union and make appointments directly. Before you go there, you can contact trading companies by telephone or telex.

In summary, you can work through trading companies, associations, trade organizations, or consultants.

Mr. **Lancaster**. Are there directors of these groups? How does a small business person know how to get in touch with these particular consultants or trading companies that you mentioned?

Mr. **Bruinsma**. They can do it the way I did it, and start from the beginning. There is a publication called *Information Moscow*. It is a handbook with everything that the Western businessman has to know about doing business in Moscow.

Mr. **Lancaster**. Do you have that telephone number or address?

Mr. **Bruinsma**. It is in the 415 area code.

Mr. **Lancaster**. One of the questions asked at the hearing last week dealt with the trade fairs, which apparently have not been used extensively up to this point in the Soviet Union. Would that be a way, if they were organized and more prevalent, or more frequent, that small business could break into the Soviet market?

Mr. **Bruinsma**. Yes; I think so. I would think that one thing that should be happening and will be happening, but I haven't seen too much of it yet, is a coalescing of small businesses around a nucleus of a larger business. I think the hotel example is a good one. I am working on a project now to renovate existing facilities in Moscow to put in Western style hotels, restaurants, theaters, and that type of thing. There is a large number of ancillary services that small businesses could handle to assist going in there. So, if you have a major hotel chain, for example, I am sure there are going to be opportunities.

Mr. **Lancaster**. This is a question to all three of you to respond, if you feel you can.

Are the Soviets more or less inclined to buy products from this country based on the relationship between our countries, and if they are, is that another good reason for creating a better climate between our countries in the future?

Dr. **Naylor**. That takes us right back to Jackson-Vanik and Most Favored Nation status. The Soviets often remind us that they are one of the few countries with whom the United States has a trade surplus. They would be prepared to buy even more from us if we would make it less difficult for them to sell their goods in the United States. The Jackson-Vanik amendment is a major impediment to the Soviets in terms of their ability to penetrate our domestic market. It should be repealed.

Mr. **Lancaster**. That is at the policy level. How about at the consumer level? Does the relationship between our countries color the consumer demand?

Dr. **Naylor**. In terms of their ability to penetrate our market?

Mr. **Lancaster**. Not their ability, but their desire to buy American goods?

Dr. **Naylor**. Their desire for American and Western goods is quite substantial. Their value system is dangerously close to that of the good old American yuppie. They want exactly the same things that our yuppies want.

Mr. **Lancaster**. Go ahead.

Mr. **George**. I think that the Soviet consumers really like Americans and American goods, all things American.

Mr. **Lancaster**. So, at the consumer level, the relationship between our countries is insignificant? Where that becomes important is at the policy level?

Mr. **George**. Yes; except to the extent that the policies may affect the business relationship. We had the grain embargo a while back. That was a principal example of how the Soviets may regard U.S. companies as unreliable suppliers. So, to the extent they feel that might happen again, they may be somewhat reluctant to purchase from us.

Mr. **Bruinsma**. I would echo those comments. It appears distinctly at both levels. At the policy level, they have been told from on top, "Do business with the United States, gather letters of intent, make it happen." Then, when you go out in the street and you talk to the common people, there is a surprising interest in Americans, a surprising warm feeling toward Americans at the people-to-people level.

I have had four or five Soviets say to me almost in the exact same terms that they consider themselves more similar to Americans than any other peoples in the world. There is a certain sympatico there. They distinguish very clearly in their minds between our government and our people. They don't hold Mr. Reagan in the highest regard, but they certainly think a whole lot of the American people. I do my best to try and explain to them that he is one of us, we do have the same feelings, although we have differences of opinion. I think they are beginning to feel that more.

They are very excited about any Western goods. They are seeing them in their advertising. They get magazines from Finland. All types of new information is coming in to them now. There is an appeal there. They would like to work with Americans more than anyone else.

I have seen evidence of the fact if you put a German, an American, and a Japanese before them, the Russians will deal with the American. There are obviously historical reasons for that. In this regard, one of the most surprising things that is happening is the warming between the West Germans and the Russians. It is phenomenal, considering the historical relationship.

Mr. LANCASTER. Mr. George, in your prepared statement you talk about opportunities for subcontracting as being a particularly profitable niche for small business. Mr. Bruinsma, you mentioned this with regard to related business to larger businesses, the hotels, that sort of thing.

Do you care to comment further on that?

Mr. GEORGE. This would apply in production ventures where the small business might be able to provide some useful inputs or technology inputs into the process, and it might be one way of addressing the major concern that a lot of American companies have with getting supplies.

They are very concerned with getting reliable supplies, quality supplies, delivered on time in the Soviet Union. One way to address that would be to hold a Western supplier as a secondary source in case the prearranged deal didn't work out, or even as a primary source.

Mr. LANCASTER. I have one last question that is completely unrelated to small business, but a matter of curiosity, and I can't let the opportunity pass to ask three experts their opinion. Before I do that, let me say again how very pleased I am personally that you could be here today and give such helpful information.

I think these hearings will be a source of important information to the Small Business Administration, to the Department of Commerce, and certainly to my colleagues on this committee. You may find that we will want to submit to you additional questions for the record. I hope that if we do, you will participate in providing those answers to us as promptly as you can.

This is my question not related to small business: I was concerned to see this week that the Soviets announced a slowdown in the withdrawal from Afghanistan, apparently as a result of their assertion that we continue to provide arms to the Mujahadin. Do any of you, or all of you, care to comment on the withdrawal timetable and what you see as the future there?

Mr. **Bruinsma**. Let me say that I am actually engaged in commercial negotiations with a businessman in Afghanistan. From his perspective, Russians and Americans come and go, but business continues there. It is obvious we are dealing in a political arena here, and I don't have access to information that the Government does. But it seems to me that Afghanistan continues to be a focal point for what appears to be Gorbachev's overtures toward progress on a broad front across the world. If we can take advantage of that without giving anything up, I would think from a political standpoint it would be most advisable.

Any opportunity for the Soviets and the Americans to work together, I think, is good for the world. I think our policy should be to take advantage of every one of those opportunities.

Dr. **Naylor**. I have no specific firsthand data or information on Afghanistan per se. But I relate it to U.S.-Soviet trade. I think in general, if one looks at Gorbachev's foreign policy, particularly vis-a-vis the Third World, there is a consistency. The name of the game is absolutely cut your losses. Maybe there will be ups and downs in terms of our preferences and tastes and how fast we would like to see him do it.

But I think if you want to predict the relationship between the Soviet Union and any country, Third World or otherwise, in the decade of the 1990's, look at the trade and technology trends for potential, but particularly with these Third World countries like Afghanistan, Nicaragua, Ethiopia, Mozambique, and Angola. The thrust seems to be cut your losses.

Mr. **Lancaster**. Is this slowdown in the withdrawal rate something temporary and tactical, or do you think that withdrawal may not proceed and may, in fact, mean a long-term presence of the Soviet Union in Afghanistan?

Dr. **Naylor**. I believe the delay will only be temporary.

Mr. **Bruinsma**. Mine as well.

Mr. **Lancaster**. Thank you very much for your testimony and for your presence here.

The committee will stand adjourned.

[Whereupon, at 12:07 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

STATEMENT OF REP. JOHN J. LaFALCE, CHAIRMAN
COMMITTEE ON SMALL BUSINESS

HEARING ON "PERESTROIKA AND ITS IMPLICATIONS FOR THE U.S."
September 23, 1988

Today marks the beginning of a series of hearings on the Economic Relationship between the United States and the Soviet Union with a particular emphasis on long-term trade prospects for American Small Business. This hearing will focus on "Perestroika and Its Implications for the United States."

In my opinion, "Perestroika" - economic restructuring - represents a fundamental recognition by the Soviets that they must begin to develop a more market-oriented economy in order to revitalize their economic system and become internationally competitive. However, before we can assess whether Perestroika would result in any significant long-term opportunities for increased trade by American Small Business -- which we will examine in greater depth next Friday -- we must examine the background and current state of our overall trade relationship with the Soviet Union, as well as the significance of its internal reforms.

Trade with the Soviet Union has traditionally been viewed within the context of our overall relationship: in terms of East-West competition; responses to regional problems; and domestic politics. As a result, our volume of trade with the Soviets has historically been small and our trade policy toward them has been characterized by "lightswitch diplomacy." For example, even at its peak in 1979, when total trade between our two countries reached $4.5 billion, this represented only about 1% of U.S.

trade. Last year, trade between the two countries was $2 billion.

At last December's summit, President Reagan and General Secretary Gorbachev urged the development of concrete proposals for the expansion of U.S.-Soviet trade. This led to the signing of a Joint Statement, at the conclusion of the April meeting of the Joint U.S.-U.S.S.R. Commercial Commission, in which both countries "strongly support expansion of mutually beneficial commercial relations ...which they believe can contribute to the development of a more constructive relationship between the two countries."

There are many different foreign economic policy approaches that the United States could take now with regard to the Soviet Union. For example, we could follow a passive policy to expand trade. This means that we would simply wait until there is even greater progress on the four major Summit Agenda items -- arms control, regional conflicts, human rights and bilateral issues -- and then respond with new trade and economic policies toward the Soviet Union. However, one problem with this approach is that the United States is already losing market share in the Soviet Union to the Europeans and Japanese, who continued to expand trade there during 1980 to 1986, when the United States did not even conduct a trade fair in that country.

Alternatively, we could adopt a more active policy -- or an active policy based on certain conditions that the Soviets must meet -- in order to enhance trade and economic relations between our two countries. Most importantly, the United States must carefully reevaluate its foreign economic policy, and particularly its trade policy, toward the Soviet Union. Next to our mutual interest in avoiding war, economic relations may hold the greatest opportunities for increased American-Soviet cooperation.

The purpose of this hearing is to examine these questions and the implications of "Perestroika" for the United States in terms of the prospects for such increased trade and economic cooperation. In particular, we will focus on the following issues: a) the significance of the ongoing and proposed Soviet reforms for American foreign-economic policy and American business; b) current U.S. economic and trade policies toward the Soviet Union in light of these reforms; c) any costs and benefits of increased economic and trade relations for both countries; and the extent to which increased trade relations might contribute to the continuation of improved overall relations with the Soviet Union; and d) Soviet market prospects and potential for American business.

We are pleased to have the following distinguished individuals with us this morning who can speak with much authority on these issues: A) Louis Laun, Assistant Secretary for Economic Affairs, International Trade Administration, and Franklin J. Vargo, Deputy Assistant Secretary for Europe, Department of Commerce; B) Dr. Marshall Goldman, Russian Research Center, Harvard University; and C) Mr. Eugene Milosh, President, American Association of Exporters and Importers, and former Vice-President, U.S.-U.S.S.R. Trade and Economic Council.

STATEMENT OF
LOUIS F. LAUN
ASSISTANT SECRETARY OF COMMERCE
FOR INTERNATIONAL ECONOMIC POLICY

BEFORE THE HOUSE COMMITTEE ON SMALL BUSINESS

SEPTEMBER 23, 1988

Mr. Chairman:

I am pleased to be here this morning to discuss the changes taking place in the Soviet economy and their implications for U.S. international economic policy.

It is a particular pleasure for me to appear before you and this Committee because I know from my experience in the Small Business Administration during the 1970's what a useful role this Committee plays in advancing U.S. economic interests, especially those of small business.

Significant economic changes, what the Soviets have termed perestroika, or restructuring, are being initiated in the Soviet Union in part, I believe, because their system for too long ignored small business. From the late 1920's, the Soviet economy glorified gigantic undertakings -- huge mills and factories, often pridefully designated as the largest in the world.

Small businesses, along with private enterprise, were virtually eliminated from this system. Political decisions by a few at the center were substituted for the economic decisions and competition of the many.

We know from our own experience that much vitality and innovation are provided by small- and medium-size firms, often new enterprises operating on a shoe string. A mix of different sized enterprises, independently run and competing with one another, is better than any other system in stimulating innovation, vitality, growth, and well-being.

Seventy years after the Bolshevik Revolution, the Communist Party's Central Committee concluded that "the centrally planned command administrative system of managing the economy has become a serious brake," and has "put the Soviet Union on the brink of an economic crisis."

SOVIET ECONOMIC REFORMS

The remedies being prescribed under perestroika are aimed at easing the strangling grip of central planners and increasing the scope for decision-making by enterprises. Output produced in accordance with mandatory state orders is to decline and be replaced by a wholesale trade system.

As part of the reform, state enterprises are to assume more economic responsibility for their costs and revenues. State subsidies are to be cut back dramatically. Wholesale and retail prices are to become more responsive to supply and demand.

Even the creation of some small businesses is being encouraged, although only in the form of cooperatives.

Foreign trade also is undergoing perestroika. For decades, the U.S.S.R. pursued a policy of autarky, or self sufficiency. By design, the Soviet economy has been highly insulated and protected. As a result, foreign trade with the West accounts for less than 2 percent of Soviet GNP.

Until recently, Soviet foreign trade has been centrally planned on a national basis by the State Planning Committee. Foreign trade transactions have been a monopoly of the Ministry of Foreign Trade.

Again until recently, the Soviets have sharply limited cooperation with Western firms. There was no Western company ownership of the means of production, no participation in management, and little in marketing.

The Soviets bought turnkey plants. By the time these plants went into operation, they often were using decades-old equipment and processes to produce decades-old products. And often, Soviet manufacturers did not get exactly what they needed, because they were working through middlemen, i.e., the national Soviet foreign trade organizations.

Recognizing these problems, the Soviets two years ago began reforming their foreign trade system. There are two major features.

The first breaks the Foreign Trade Ministry's monopoly of foreign trade. More than 100 Soviet ministries and enterprises have been authorized to deal directly with foreign companies, including the right to sign contracts and to retain a portion of hard currency earned through exporting.

The second measure authorizes new forms of cooperation, including joint ventures, with foreign firms.

While about 300 joint ventures are being discussed between Western companies and the Soviets, only about sixty have been formed to date. They tend to be small, because Soviet joint venture policies are difficult -- particularly a Soviet requirement that joint ventures must export to the West. Most Western companies interested in joint ventures want to sell in the Soviet market, not to create a Soviet manufacturing plant to supply Western markets already adequately covered.

According to the Soviets, Western companies have invested only about $30 million in capital so far. Many of the joint ventures will be implemented in a series of stages, with investment and introduction of production processes phased in over a number of years.

Judging from the experience in other communist countries, and in the Soviet Union itself, joint ventures are not likely to play a major role in Soviet foreign economic relations for some time. But they represent a significant step by the Soviets to open up to the West and to become more integrated in the world economy.

U.S. ECONOMIC POLICY

Soviet trade reforms are far-reaching, but they, like the broader economic reforms, are just beginning. Implementation of the reforms and revamping of the Soviet economy and foreign trade system will take time.

The success of perestroika depends almost entirely on the Soviets. The West's ability to influence the success or failure of perestroika and other reforms is limited. The West did not create the problems of the East, and would not be able to solve them -- even if that were the objective. Improvement in the Soviet economy can come only from genuine and far-reaching changes in the Soviet economic system itself.

I believe that the trade policy which the Reagan Administration has put in place enables us to deal with the changes occurring in the U.S.S.R. now, and to take advantage of the commercial opportunities.

Our policy is founded on the view that security and political interests, including our concern for human rights, dominate the bilateral relationship, and that economic cooperation cannot be viewed separately from the total relationship.

Our national security needs remain paramount. Strategic goods and technology are not areas where we are, or will be, interested in trade expansion. Our own and multilateral controls on the export of militarily useful goods and technology must be maintained vigilantly.

Secondly, the Administration is firm in its support of the Jackson-Vanik Amendment to the Trade Act of 1974, relating Most-Favored-Nation (MFN) tariff treatment to freedom of emigration. Without sustained and substantial emigration from the U.S.S.R., there will not be MFN treatment for Soviet products in the U.S. market.

Government export credit and credit guarantee programs are governed by the same Jackson-Vanik criteria as MFN. We do not extend Government export credit programs to the U.S.S.R. In addition, we are firmly committed to the 1983 Williamsburg Summit principle that Western Governments should not provide subsidized export credits to the East. Exports should take place on commercial terms.

With regard to joint ventures, President Reagan and General Secretary Gorbachev agreed at the December 1987 Washington Summit that joint ventures could play a role in the development of commercial relations.

U.S. laws and policies are in place to handle any transfer of technology involved in joint ventures. Any proprietary technical data transferred to the U.S.S.R. must have an export license, including within joint ventures.

Within this framework, our policy is to seek step by step improvements in trade where possible -- strictly in non-strategic areas. Since resuming bilateral trade talks in 1985, we have attempted to gain market access and market information. In 1985, the Soviets agreed to make bid information available to American companies and to consider their proposals on economic grounds.

In April of this year, the Soviets agreed to allow access for Soviet officials and enterprise representatives to the U.S. Commercial Office in Moscow and permit distribution of a U.S. commercial newsletter to Soviet businesses.

Steps such as these, coupled with Soviet implementation of perestroika, will gradually expand the possibilities for business. Growth, however, will be slow. The primary limiting factor is the U.S.S.R.'s shortage of hard currency.

The Soviet market for industrial nation manufactured exports is only about $12 billion annually. Ninety percent of the market is held by European companies. U.S. exports have only 3 percent of this market, a considerably smaller share than we have globally. The best prospects for U.S. export growth to the U.S.S.R. in the near term will come from increasing the U.S. share of the market.

The Soviet market is a tough market. It is definitely not for the trade neophyte. Winning contracts is a drawn-out and costly affair. Signing one's first business deal may take two or three years and involve numerous costly negotiating trips. Problems of language, technical translations, and different standards abound. These costs and demands are beyond the resources of most small businesses.

This is not to say that every contract takes two years or that no small business can succeed in the Soviet market. There are contracts quickly arrived at and small companies doing good business. But these are the exceptions, not the rule.

Some small companies may find an avenue into the market by using experienced trading companies or representatives. Others may be able to link up as sub-suppliers to Western companies using their products and doing business in the Soviet Union.

Many, however, will do well to look elsewhere for profitable export markets.

Thank you.

American Association of
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TESTIMONY

by

Eugene J. Milosh

President

AMERICAN ASSOCIATION OF EXPORTERS AND IMPORTERS

before the

United States House of Representatives

Committee on Small Business

on

Perestroika and its Implications for the United States

September 23, 1988

I am Eugene Milosh, currently President of the American Association of Exporters and Importers. Previously for a period of twelve years, I was with Union Carbide Corporation involved in market development in Eastern Europe and subsequently served as Vice President of Operations for the US-USSR Trade and Economic Council during the rise and demise of Detente from 1973 to 1980. In my current position with AAEI we represent over 1200 US firms nationally, large and small, in various aspects of international trade relating to legislation, trade restrictions, export controls and Customs matters. Many of our members are active in non market economics of the P.R.C. and Eastern Europe, and to a much lesser degree with the Soviet Union.

Before expressing my views on the impact of perestroika within the Soviet Union and its prospects for increased trade and economic cooperation with the United States, I would like to make some observations from a broader perspective.

As a businessman closely involved in U.S.-Soviet economic relations since the 1960's I am thoroughly amazed by the change that has occurred in the Soviet Union during the past four years. While it was obvious to most western observers that the Soviet economic system was seriously flawed, isolated and not on the same wave length as the rest of the major economies, the prospects for change were not apparent. After all, the Soviets had lived with their rigid system for more than 50 years with resignation and subservience to the priorities of Mother Russia during two World Wars and periods of reconstruction requiring sacrifice for a common purpose. However, Soviet intervention in Afghanistan caused all this to change as well as ending Detente. The years of resignation began to falter, revealing economic inadequacies of the system with little hope of improvement. The long pent up aspirations of Soviet people to increase their standard of living stretched the situation to a point of tearing apart the ideological fabric. "Glasnost" institutionalized self examination, and "Perestroika" set in motion a long process for change. How the United States responds to perestroika can influence its outcome. At the least, we should let it be known what conditions we would expect for an improved economic relationship that heretofore was practically non existent. And let those who oppose any relationship with the Soviet Union ponder the fact that even with the demise of the current regime, there would not be an improvement in our national security. As Richard Barnet author of Real Security: Restoring American Power in a Dangerous Decade stated "The most likely consequence of a precipitous change in the Soviet Union would be anarchy and civil war amid the tens of thousands of nuclear weapons on Soviet soil. This is nothing we should wish for, much less try to bring about". These words were written in 1981, before Mr. Gorbachev and before "Perestroika".

Beyond broad policy implications, there have been serious practical barriers and misunderstandings that have been encountered by the business community in dealing with the Soviet Union. Because these commercial problems are real on an operational level, it is important to enumerate some of these to determine if perestroika will indeed overcome these barriers or if the principles of perestroika can somehow be expanded to accommodate U.S. business concerns.

Fundamentally, United States suppliers entering the Soviet market are faced with many subtle protectionist tendencies. With the Soviet inconvertible currency, hard currency must be allocated by industry or a Ministry, leaving a U.S. supplier at the bottom of the list unless there is a special priority for his particular product, spare part, machinery or technology. While availability of credits from the West could partially mitigate this situation, a U.S. supplier is still not on the same level as a Soviet enterprise selling to another enterprise or a supplier from Eastern Europe, despite apparent quality advantages.

Even more striking is the structural competitive passivity that has existed in Soviet exports. Soviet enterprises unable to reach out and comprehend world market conditions and without incentive to earn hard currency for their own account were placed in a semi-conscious economic slumber which apparently is only now being addressed.

Furthermore, denying importers and purchasers access to factories where decisions might be made locally, has further insulated the possibilities for redesigning products, modernizing plants and adapting to market conditions. In this context, the role of U.S. importers, retailers and subcontractors should not be minimized as a means to growth. These U.S. firms, mostly medium and small in size, have assisted immeasurably in developing exports in many other parts of the world in every product line imaginable. This has been particularly true in the P.R.C. and Eastern Europe for consumer type products. These same firms are able to do business with the Soviet Union and could not only bolster their export potential, but domestic potential as well if the climate and structure for a lasting business relationship fulfills the promise it holds for both sides. Instead of placing too much emphasis on a hand full of large projects exemplifying national pride and massive achievement, it may be more prudent and beneficial to proceed on a variety of smaller ventures and business transactions that have a greater chance of success and, in the aggregate, would be more beneficial to the economy. Certainly with regard to political, domestic, bureaucratic and trade law hurdles, a broader approach would have inherent advantages. Other negative operational behaviors prevalent in U.S.-Soviet trade include:

- U.S. firms frequently relegate responsibility for Soviet trade to European affiliates or distributors, thereby losing opportunities for direct contact and the benefits of direct exchanges. This often leads to distorted country of origin trade information. This lack of direct contact is especially true for medium and small size firms. The Soviet foreign trading organizations with restricted authority to reach out are comfortable dealing with middlemen and intermediaries who serve a useful function, but who are sometimes of questionable repute. This practice exacerbates the lack of business confidence and creates an aura of mystery and intrigue, which attracts con men. I recall an incident in the late seventies when a Midwestern automotive parts firm was convinced by an intermediary that a contract had been concluded with the Soviets only to find out later, having already paid a commission, that none was concluded.

- Rather than relying on an incentive system, a Soviet practice of petty gift and favor giving, combined with bureaucratic privileges and allowances to government officials, is difficult for outsiders to understand. This leads to subtle corruption that can be frustrating to U.S. businessmen.

- A Soviet misconception that large firms constitute the "ruling circles" of the U.S., and consequent over-reliance on their influence in changing U.S. trade policy vis-a-vis the Soviet Union. Now, moreover there is a void created by attrition of the involved corporate moguls of the Detente period. The new breed of corporate leaders are now preoccupied by problems and opportunities elsewhere.

- To bid on contracts, U.S. firms invest heavily in proposal preparation to meet Soviet standards. This requires detailed design, engineering, equipment specifications and pricing breakdowns. Since the Soviets usually do not pay upfront for proposal preparation and bidders are kept in the dark, many firms are vulnerable to "whipsawing" and compromising technology and know-how. In one case a $2.5 billion integrated plant proposal requested by the Soviets involved tens of thousands of man-hours to prepare. After more than three years of meetings, "delegation" visits and toasts to everlasting friendship, the project was whittled down to a $300,000 technology agreement and finally rejected.

The Soviets fear the United States is an unreliable supplier, because of policy interference, such as inconsistencies in export control regulations, and because of experiences of off-spec, beyond shelf-life and inferior quality deliveries. The latter can be attributed to over aggressive bidding, one-shot deals, and the practice of purchasing without technical assistance and start-up provisions. In another case in the 1970's a U.S. chemical engineering firm won a contract by underbidding its nearest competitor by 30% only to find the project in financial difficulty and consequent inability to meet deadlines and performance requirements.

Lack of hospitality accorded Western businessmen which currently involve exorbitant fees for hotels, meals and business services. Consideration should be given to a special lower business class service. In terms of developing trade, it would pay for itself and attract more small and medium size firms who are more cost conscious.

Smaller firms are willing to explore the Soviet market but can only devote limited time - perhaps one or two trips - to determine if there is a concrete basis for business. This means the Soviet Union must not only be hospitable in a limited time frame, but should also establish easy access to trade officials, institutes, and enterprises as well as facilitate efficient scheduling of appointments, travel arrangements, plant visits, trial runs, and the like. A frustrated businessman seldom returns to be intimidated - only large, project oriented firms, having staff commitment and possessing resources allowing for greater patience and endurance can afford to do so.

In the absence of real market access as practiced in the Western world, a mechanism to facilitate the business interests of small and medium size firms wishing to import or export with the USSR is sorely missing. As history has demonstrated, a centralized system of purchasing and selling for an entire economy does not meet access needs. Furthermore, U.S. Associations or bi-national Councils, while serving a useful purpose in promoting trade relations and public relations, are not equipped nor should they undertake the task of facilitating trade transactions between the U.S. business community and Soviet organizations. In this regard there have been charges of corruption and the appearance of conflicts of interest. Instead, it is the primary policy responsibility of Soviet authorities to establish a mechanism or structure to facilitate and expedite business with small and medium size firms. With market access, combined with proper facilitation, trust and confidence are improved in a business sense. That is, transactions, trade barriers, tariffs, cost of production, domestic pricing and supply and demand factors become more transparent - which is just what the GATT is attempting to accomplish on a world wide basis.

Not surprisingly, current results of perestroika in accommodating the needs of business are lackluster despite Soviet pronouncements, extensive media coverage and meetings of Heads of State. During a four year transition period there are signs of progress, but for the firms involved in foreign trade, little improvement and much chaos. Consider for example:

- Many U.S. businessmen find it even more frustrating in dealing with Soviet officials. Since approximately 40% of the staff in the Ministry of Foreign Trade, once a corp of elite, will lose their jobs, confusion prevails. Many Soviets candidly lament they do not know where they will be next month. Whereas you could expect three appointments a day in the past, three appointments a week is the current rule. Obtaining a decision is much more difficult.

- Joint venture regulations, although relaxed, are limited in application and interest due to lack of ruble convertibility and confining possibilities for repatriation of profits in dollars. While unique schemes involving catering to tourists in a few Soviet cities have provided symbolic possibilities to earn hard currency, application on a national level is limited indeed and resented by Soviet citizenry. Basically joint ventures are attractive only to large firms willing and better able to speculatively invest in order to obtain a future foothold in the Soviet market. This means waiting for ruble convertibility which most U.S. and Soviet economists believe will take anywhere from five to ten years, if at all. Approval of joint ventures within the Soviet structure although more decentralized, is nevertheless cumbersome and uncertain. An industry official in the Ukraine may favor it but a central planner in Moscow may have reservations because the decision is no longer solely his.

- Price reform under Perestroika is still years from reality. Presently, there is a dual pricing system prescribing state allocations based on contract prices that does not make for an internal distribution system relying on market principles. Soviet planners are able to establish "minimum resale prices" distorting any market oriented pricing structure. A good deal more enterprise to enterprise free market pricing will need to take place with a parallel decline in the volume of State allocation orders issued by central planners for local enterprises. Recently it has been reported that 20% of local enterprises are withholding up to 20% of their capacity from State allocations but have limited prospects for sales to other enterprises. This is a sure sign for a Soviet economic recession or inflation! Obviously, it may reignite a return to a full command economy.

- Local enterprise access to foreign markets is still a myth. Although up to 60% of selected enterprises are scheduled to conduct foreign trade, they are required to go through collectives or middlemen which has not been defined nor has it resulted in improved market access for U.S. importers and exporters. Mr. Abel Aganbegyan the chief architect of perestroika has stated "direct dealing by Soviet enterprises will take place in two or three years but even then only through authorized collectives and middlemen which are still undefined".

In summary, given all the commitments to perestroika embraced by Mr. Gorbachev, it still appears uncertain in terms of its effect and the ability of the Soviet Union to conduct international trade with the West. The restructuring has yet to take a firm hold in its economy and unlike the P.R.C or even certain CMEA countries such as Hungary, the Soviet economy is still governed by central planners and managers.

Under these circumstances it is incumbent upon the United States to encourage the expansion and faster pace of perestroika rather than encouraging U.S. business to leap into a confusing situation whose outcome is uncertain. Basic arguments in this direction could include:

- We must encourage restructuring under perestroika not only to be done on a national basis, but to be international in perspective. In essence for perestroika to be effective, it must be extended to international trade and embrace the principles of international trade.

- Improve trade facilitation with the Soviets by encouraging the service industry to be included in opening of the Soviet economy. This includes banking, accounting, retailing, advertising, customs brokers, freight forwarders, business communications, hotels, tourism etc.

- Develop a U.S. policy towards possible Soviet accession to the GATT. There are many proposals being discussed by various trade and business groups with many novel approaches ranging from a dual membership status for non-market economies to establishing criteria such as tariff reductions, import penetration and acceptance of fundamental rules of trade being discussed in the Uruguay Round which is not due for completion until 1990. These include safeguard codes, intellectual property rights, inclusion of service industries and concepts of transparency in regulations and statistics. Obviously, when the GATT was founded very little thought was given to non-market economies although mention in article 6 recognized special problems would exist in determining pricing relative to anti-dumping and countervailing duties from monopoly state trading nations. There, nevertheless, remains a great deal of skepticism in allowing the Soviets to join GATT as opposed to other NME's due to its rigid system and sheer size threatening a politicization of the GATT. However, the advent of perestroika and European plans for 1992 suggests the United States take the initiative to set an agenda by collaborating with our trading partners to craft a policy of encouraging perestroika as a means towards broader reliance on competitive principles. For instance, basing imports on commercial factors and within a price system that market economies would understand as being transparent under conditions of supply and demand. Some have even suggested that the Soviets be granted a limited observer status allowing time to decide the prudent course without any downside in damaging the GATT structure. Whatever approach is adopted, it should be recognized that the GATT has always had as a principle objective the improvement of the world economic order and at the same time the goal of maintaining peace among nations - all nations.

Redefine the role of the bi-national U.S.-U.S.S.R Trade and Economic Council. The U.S. and U.S.S.R governments in 1972 established the Council under a separate protocol agreement signed by President Nixon and General Secretary Brezhnev. While the trade agreement of 1972 was renounced by the Soviet Union because of the Jackson Vanik amendment, the Council nevertheless continued. Now, 15 years later, the original mission of the Council under Detente should be reexamined to better serve todays needs under perestroika and glosnost. In the 1970's, large U.S. firms and Soviet centralized organizations controlling foreign trade dominated council activities. Members were geared to furthering large projects and ingratiating their posture to maintain sales volumes. The mission of an updated bi-national Council should encourage small and medium size U.S. firms be represented on the U.S. side as well as local enterprises on the Soviet side. As a quasi governmental body, any semblance of large company dominance or suggestions that the Council is a business club allowing special influence should be remedied immediately. Otherwise, the Council and United States credibility will suffer with the council becoming a public relations arm of the U.S.S.R. in the United States with very little reciprocal benefit for the United States in the Soviet Union.

A greater dialogue should take place with Soviet officials and organizations at all levels with U.S. government agencies, Congressional Committees and industry/professional groups to focus in and attempt to resolve the many operational and administrative problems that prevail. Under the banner of perestroika, many changes can be made to accomodate U.S. business. For instance, a mechanism to facilitate industry to industry meetings, changes in visa policy, an imporovement in lowering the cost of business accommodations, joint seminars on management techniques, advertising, etc., to name a few. Of course there are other more bold policy oriented decisions that have been suggested by U.S. experts on Soviet relations. For example, Professor Bialer from Columbia suggests the Soviet Union consider importing large volumes of shoes and other consumer products as part of a "Marshall Plan" to help perestroika endure a very crucial transition in the next two or three years. The point is that perestroika and Communism contain many anomolies that can induce many subtle as well as not so subtle changes if construed to benefit the Soviet Union in its transition period.

In summary, the United States and our trading partners should welcome perestroika as a positive step in Soviet economic development. While at this stage there are limited opportunities for U.S. business expansion, there may be opportunities to reduce administrative and operational type barriers. Continuation of perestroika should be fostered, especially application of its principles to the conduct of foreign trade. Moves in this direction would justify the United States and other market economies to review Soviet participation in the GATT on a preliminary, conditional or special case basis. In all our dealings with the Soviet Union, the interests of small and medium size firms should be maintained, and redefined within existing organizations, to embrace the decentralization, market access and market orientation inherent in perestroika. The American Association of Exporters and Importers would be pleased to assist the Committee on Small Business in this endeavor.

STATEMENT OF REP. JOHN J. LaFALCE, CHAIRMAN COMMITTEE ON SMALL BUSINESS

HEARING ON "PROSPECTS FOR INCREASED TRADE WITH THE SOVIET UNION BY AMERICAN SMALL BUSINESS"

Today is the second hearing in a series of hearings on the Economic Relationship between the U.S. and the Soviet Union with a particular emphasis on American Small Business. The purpose of today's hearing is to examine the long-term trade prospects for American small business as a result of the current or proposed Soviet reforms.

This is a particularly timely subject given the recent developments in the Soviet Union this week. The Soviets and Americans have apparently made major progress in negotiating joint ventures; and as a result, members of the American Trade Consortium -- some of whom had planned to be with us here today -- have gone to Moscow to join these important negotiations.

Last Friday, we heard from a variety of witnesses that there would be increased opportunities to expand trade with the Soviet Union provided that the policy of "Perestroika" is successful. However, at this time, this remains to be seen.

In my opinion, the success of "Perestroika" is clearly in the United States' interests. However, American small business is not in a position to rush in to increase trade with the Soviets until we have a greater understanding of the impact of "Perestroika," as well as the prospects for continued stability in our relationship with the Soviet Union.

As the economic relationship between our two countries continues to develop, ways to enhance trade opportunities for American small business should also be considered for several reasons:

First, there are already over 100 small and medium-sized businesses engaged in trade with the Soviet Union, according to the Department of Commerce. These small companies carry out direct or barter trade with the Soviets in areas such as food processing; computer software; clothing; medical equipment; and services.

Second, there is a new emphasis in the Soviet Union on the development of small business, known as private cooperatives. Over 20,000 private cooperatives have been formed so far, which would provide a novel alternative to American small firms that want to do business in the Soviet Union. The Soviet Union now recognizes the importance of developing a small business sector as a way to achieve economic reform and growth.

Third, changes in the Soviet trade structure and laws, such as the establishment of joint ventures between Soviet and American firms, and the ability of private cooperatives to engage directly in trade with foreign counterparts, may open up major new trading opportunities for American small business.

Today's hearing will focus, in particular, on the following issues: a) the long-term opportunities, in terms of Soviet market priorities and prospects, that would be available for small business in the Soviet Union; b) the constraints, from both an American and Soviet viewpoint, that must be overcome in order for American small business to expand trade; and c) the strategies and policies that should be developed to take advantage of any new opportunities.

We are pleased to have the following individuals here this morning who can speak with authority on these issues: A) Dr. Thomas H. Naylor, Professor of Economics at Duke University and author of The Gorbachev Strategy; B) Arthur L. George, from the lawfirm of Baker & McKenzie, Washington, D.C., who is actively involved in negotiating American-Soviet joint ventures; and C) Tim Bruinsma, Director of Pacific Intertrade in Los Angeles, Senior Partner at Hill, Farrer & Burrill in Los Angeles, and advisor to the California World Trade Commission on small business trade opportunities.

PREPARED STATEMENT OF

THOMAS H. NAYLOR

Professor of Economics
Duke University

before the

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

September 30, 1988

PERESTROIKA: NEW OPPORTUNITIES FOR SMALL AMERICAN BUSINESSES IN THE SOVIET UNION

Beginning with his February 25, 1986, speech to the Communist Party Congress, Soviet leader Mikhail S. Gorbachev has repeatedly called for "radical reform." However, since he has neither denounced Marxist-Leninist ideology nor embraced capitalism, ~~cynics claim~~ we are told that it is business as usual in Moscow. Nothing could be further from the truth. There is mounting evidence that Gorbachev means exactly what he says. The name of the game is indeed radical reform -- radical reform of the Soviet economy, culture, political structure, and foreign policy.

Gorbachev's strategy calls for nothing less than the de-Stalinization of the Soviet Union and includes a direct assault on the centrally planned economy, the inflexible government bureaucracy, the self-serving Communist Party, and even the KGB.

The Soviets are being driven towards radical reform by a combination of internal problems within the Soviet Union as well as a number of international forces, all of which predate Gorbachev's rise to power on March 11, 1985. Since these internal and external forces are all quite independent of Gorbachev the man, we believe the Soviet reforms will continue with or without Gorbachev. The domestic problems, many of which existed before the 1917 Revolution, include a stagnant economy, inefficient agriculture, an inadequate supply of consumer goods and services, a substantial technological gap with the West, a rigid political and governmental structure, a police-state mentality, a high death rate, and an increasingly alienated population. On the international side, the Soviets have been influenced by the economic and foreign trade policies of Hungary, China, Japan, Sweden, Finland, and West Germany as well as the foreign policy of the Reagan administration.

A New Social Contract

If the new CEO of a major U.S. company such as Ford or IBM wants to introduce fundamental policy changes, then the CEO must come to grips with the company's culture -- the attitudes, values, and customs of the company's managers and employees. The failure to address strongly ingrained cultural factors has led to the demise of many a new CEO in the United States.

This is precisely the situation in which Mr. Gorbachev finds himself as he attempts to change the philosophy of management of Soviet managers. If Gorbachev is to succeed, he must confront the culture of the largest risk-free society in the world. But that is exactly what he is doing, and he is doing it very effectively.

Through his dual strategies of glasnost (openness) and perestroika (economic and political restructuring), Gorbachev is attempting to negotiate a radical new social contract with the Soviet people. In exchange for more personal freedom, individual citizens are being encouraged to assume more risk and responsibility for their individual lives.

Until very recently, managers of most Soviet companies had little control over which products they produced, how they were produced, the prices that would be charged, and how they would be marketed domestically and internationally. All of the planning for such firms was highly centralized, top-down planning imposed on the company managers by the appropriate Government ministries. Soviet managers had no responsibility whatsoever for sales and marketing. They simply produced the goods according to plan and turned them over to another government bureau to distribute. Under such a rigid system, there were few incentives for innovation or the efficient use of scarce natural resources. Nearly all research and development was done in huge centralized research institutes in Moscow -- far removed from the marketplace. Thus, the Soviet Union found it virtually impossible to compete in international markets.

Since January 1, 60 percent of the Soviet Union's 48,000 industrial companies are required by law to be financially self-sufficient. No longer will GOSBANK, the official state bank, extend credit to companies that are unprofitable, have large unsold inventories, or make poor-quality products.

Under the new system of local control called khozraschot, Soviet managers have been given a great deal more decision-making freedom than was the case in the past. They are not only allowed to make their own product-mix and production volume decisions in response to market demand, they may also purchase raw materials from alternative suppliers and hire and fire employees based on market needs and their performance. Soviet managers may even make their own wage decisions within guidelines provided by GOSPLAN. Higher wages will be paid to managers and workers in such high-priority industries as computers, machine tools, and robotics. A portion of a company's profits will either be reinvested in the business or shared with the managers and employees as a form of incentive compensation.

The Foreign Trade Environment

In no area are Gorbachev's reforms more radical than in international trade. His fundamental objective is to strengthen the Soviet economy and reduce international political tensions through a strategy of increased global interdependence based on bilateral trade between the Soviet Union and the rest of the World.

The Soviets must increase the quality and quantity of their exports to the West to finance their much-needed imports of consumer goods, technology, and foodstuffs. Imports help break the monopolistic stranglehold some Soviet enterprises possess over certain industries. More imports mean more competition in the domestic market.

Gorbachev has learned form the Japanese that the number of nuclear warheads in a nation's arsenal is not nearly such an important measure of international political power as it once was. Economic clout has become a much more important measure of political influence than military might.

Since January 1987, nearly 100 Soviet state-owned enterprises can now trade directly with the West. Foreign companies may own up to 49 percent of the equity in Soviet joint-venture companies. Repatriation of profits, reinvestment tax incentives, third country operations, and expropriation protection are all part of the package. The Soviets have indicated an interest in joining GATT (General Agreement of Tariffs and Trade), the World Bank, and the International Monetary Fund. Special trade zones, the creation of financial and banking institutions, and a freely convertible ruble are also in the works.

The power of the international marketplace is one of Gorbachev's most important instruments of change. He is much more interested in exporting Soviet-made goods and services rather than communism.

As a result of last year's $170 billion trade deficit, it is not surprising that an increasing number of American companies are looking for new markets in such places as the Soviet Union and Eastern Europe. Intense foreign competition combined with severe import restrictions imposed by Third World nations straining under huge debts to U.S. banks have aggravated the problem.

The Soviet Union is one of the very few countries with which the U.S. consistently has a trade surplus. However, this surplus shrank in 1986 and 1987 because the sharp drop in the price of oil has reduced foreign currency available to the Soviets to buy American goods. For the past two years, two-way trade between the two superpowers averaged a paltry $2 billion per year, down from a high of $4.5 billion in 1979. However, during the first quarter of 1988, U.S.-Soviet trade increased by 270 percent over the comparable period in 1987.

Increased U.S.-Soviet trade has a favorable impact on U.S. employment. Economists estimate that as many as 40,000 new jobs are created by each $1 billion in increased trade. Before our government imposed sanctions against the Soviet gas pipeline in 1983, Caterpillar had 80 percent of the Soviet market for heavy duty earth-moving equipment, while Komatsu of Japan had only 20 percent. As a result of the sanctions, Komatsu's Soviet marketshare jumped to 80 percent, and nearly 15,000 jobs were lost at Caterpillar. The pipeline was completed ahead of schedule.

The Soviet Union offers the U.S. an untapped consumer market of over 280 million people as well as a highly concentrated market for large-scale contracts. It also has vast reserves of hydrocarbons and energy, which make it an increasingly attractive trading partner as the U.S. supply of crude oil continues to tail off.

High-Tech Opportunities

Critics of East-West trade claim that the only reason the Russians are interested in trade with the West is to obtain technology to achieve military superiority. The Russians are often depicted by the Pentagon as scientific incompetents who must either buy or steal all of their technology from the

West. But the thirty-year history of the Soviet space program is impressive evidence of their achievements in science and technology. Some of the best mathematicians and scientists in the world are Russians. They have state-of-the-art technology in medicine, lasers, space technology, steel production and nonnuclear power engineering. We are the beneficiaries of Soviet advances in coal gasification, welding, electromagnetic casting and metallurgical processes. Soviet-bloc countries hold over 5,000 U.S. patents and some of their technology is even used by Pentagon contractors to develop weapons systems, including the Strategic Defense Initiative.

The Soviets are much better at basic research than applied research. The Americans and the Japanese are stronger in converting technology into marketable products. These differences provide a unique opportunity for scientific cooperation and joint ventures -- a point which the Japanese, West Germans, and Swedes have been much quicker to grasp than Americans.

With the high cost of R&D in the U.S. and the Soviets' strength in basic research, joint ventures combining Soviet research with U.S. product development and marketing skills could become increasingly attractive to U.S. firms. European drug companies such as CIBA-GEIGY and the Wellcome Foundation have had successful joint clinical studies with Polish scientists for several years.

Restrictions on the export of American technology to the Soviet Union are not new. But for the past eight years the Reagan administration has adopted an increasingly restrictive policy, which a National Academy of Sciences panel criticized recently for being "not generally perceived as rational, credible and predictable."

One result of the Pentagon's efforts to curtail the shipment of microcomputers to the Soviet bloc has been the creation of a thriving new industry in Eastern Europe -- privately-owned manufacturing companies producing clones of American computers. Many types of high-tech equipment that are restricted by export controls are readily available in the Soviet Union and Eastern Europe.

Inter-Design is typical of the new firms that have emerged in Warsaw since the mid-1980s. Financed by a $3,000 investment from a Swedish businessman in 1983, Inter-Design produces state-of-the-art microcomputers and process control devices for Eastern Europe, the Soviet Union, and China, and computer software that it sells for hard currency in Sweden. According to its president, Leonard Zabielski, the firm is extremely profitable and employs thirty people, most of whom are top-flight electrical engineers attracted by "good pay, hard work and extremely interesting projects." None of this would have been possible were it not for our government's tough stand on technology, which restricted the supply of American-made computers to Poland.

According to the National Academy of Sciences panel study mentioned earlier, the Defense Department's effort to crack down on the diversion of technology to the Russians has essentially failed and is costing the U.S. economy over $9 billion a year. The belief that current export controls are unduly restrictive, even counterproductive, is gaining ground in both political parties and among military and intelligence experts. In fact, there is increasing evidence to suggest that the Pentagon's obsession with denying the Soviet Union access to Western technology may inadvertently be strengthening the hand of the Russians technologically. Scientists in Moscow routinely rely on what Harvard Business School professor Michael Porter calls "market signals" from the Pentagon to help formulate their own technological priorities. They give the highest priority to projects that are most closely related to the technologies that the Pentagon tries the hardest to deny them.

American Challenges

For many years the Soviet Union has borne the brunt of American jokes about the poor quality of their consumer goods. A 1985 Wendy's television commercial ridiculed Soviet fashions by featuring a matronly Soviet woman dressed in a drab, potato-sack-like dress. Cynics claim that Soviet leader Mikhail S. Gorbachev's efforts to internationalize the Soviet economy are doomed to failure because of the Soviets' inability to produce world class consumer goods. But there are signs that this may be changing.

The real significance of the entry of McDonald's into the Soviet market is its role as a prototype for service sector firms to follow. Since May 1987, The Soviets have begun privatizing the service sector of their economy. Already there are over 14,000 private cooperatives in the Soviet Union including small restaurants, boutiques, beauty salons, and auto repair shops. There are 70 private restaurants in Moscow alone.

To increase the quality and quantity of Soviet-made goods, Gorbachev has offered financial incentives to motivate managers and employees alike. Previously such incentives met with only limited success, since there were no high quality consumer goods available for which the Soviets could spend their extra rubles. French designer clothes and other consumer goods imported from the West help energize the reforms.

As evidence of how difficult it is for people to find anything on which to spend their extra rubles, savings banks hold deposits equal to $1,700 for every man, woman, and child in the Soviet Union. This per capita savings figure represents a half-year's salary for most Soviet workers and indicates that they save a much higher percentage of their income than do people in the U.S. or other Western industrial countries. Last year the average American saved only 3.7 percent of his or her income, while Japanese workers put aside 15.6 percent of their income.

Which comes first: the production of world class consumer goods or the use of high-quality consumer goods to encourage the production of improved-quality Soviet products? In no sense has Gorbachev completely sorted out this complex problem. However, he has taken some very interesting first steps.

Since the days of Lenin, the Soviets have maintained a strong interest in U.S. trade. Political ideology has never been a problem for Soviet officials in their trade relations with the U.S. Today Marxist-Leninist ideology seems to be much more important to some American politicians than it is to Soviet managers. The U.S. is paying a high price for its inability to compete internationally. Ironically, the Soviets have a similar problem.

American businessmen have two options as to how they may respond to the revolutionary new Soviet trade initiatives. They may either sit cynically on the sidelines and wait until the new Soviet trade and joint-venture laws have been cast in concrete, or they may opt to work with the Soviets to help create a set of joint-venture laws and practices which are mutually advantageous. If American businessmen do choose to lay out during the opening round, they may find themselves squeezed out of future rounds not only by West Germany and Japan, but also by China, Israel, India, Brazil, Argentina, and Mexico, to mention only a few.

Corporate giants such as Dow Chemical, Abbott Labs, Pepsico, and Occidental Petroleum have traded with the Soviets for years. More recent U.S. entries into the Soviet market include Combustion Engineering, American Express, PC World, Chevron, Pizza Hut, Baskins-Robbins, Ben & Jerry's Ice Cream, Eastman Kodak, Coca Cola, Johnson & Johnson, RJR Nabisco, and Ford Motor Company. It is now possible for much smaller American firms such as

Southwire Company of Carrollton, Georgia, Jerry Bobo Jewelry Company of Chattanooga, Tennessee, and Merrick Engineering of Nashville to do business in the Soviet Union. Merrick employs 38 people. My two favorite firms operating in Moscow are Lafitte's Landing Louisiana Cajun Restaurant and Delta Catfish of Indianola, Mississippi.

The two major Soviet impediments to Gorbachev's economic reforms and increased U.S.-Soviet trade are not political ideology or government bureaucracy. Rather they are the lack of convertibility of the ruble and Soviet managers' lack of experience with market-oriented management practices -- both of which are expected to change.

Once flexible prices are introduced in the 1990s, a convertible ruble will not be far behind. In the meantime, six American companies recently formed a consortium which will facilitate taking profits out of the Soviet Union in hard currency.

To deal with the plethora of problems faced by the managers of their large industrial companies, the Soviets have developed a multidimensional strategy for improving management practices including education abroad, executive education programs, and private management consulting firms. Some Soviet managers will take courses in Budapest at the East-West Management Institute -- the first Western-style graduate school of business in the Soviet bloc. Others will enroll in MBA programs in Western Europe and the United States.

In May 1987, the first private American management consulting company, Peterhof, began operations in Moscow amid considerable fanfare from the local press. Several other American management consulting firms are now doing business in the Soviet Union.

Two of the biggest obstacles in the U.S. to increased East-West trade are the U.S. government and professional Sovietologists, including academics and journalists.

The U.S. Congress and the Reagan administration have created some truly formidable obstacles to increased U.S.-Soviet trade including export controls, import controls, financial controls, and other political and legal constraints. If we mean what we say about wanting to encourage the Soviet Union to become a more open, market-oriented society, then we should offer them more positive encouragement while continuing to protect our national security interests. This means easing restrictions on U.S.-Soviet trade where these have gone beyond reasonable boundaries and supporting Soviet membership in GATT, the World Bank, and the IMF. If we truly believe in the power of the free market, then why don't we give it a chance to work in the Soviet Union?

Even though there is increasing evidence that perestroika is here to stay, many Sovietologists continue to cling to the notion that radical reform is impossible and that Gorbachev is doomed to failure. They view each new Gorbachev reform as though it will probably be his last. The possibility of increased East-West trade is considered to be a myth. There is no room in the temple of doom for a Russian optimist like Gorbachev with a positive vision of the future.

Some conservatives oppose any trade with the Soviet Union and Eastern Europe on the grounds that increased trade may strengthen the Soviet economy and threaten the national security of the United States. In my view, a Soviet Union which is stronger economically is less likely to need to pursue an aggressive foreign policy to demonstrate its credibility as a superpower. A more affluent Soviet Union has more to lose in the event of war and is less likely to be as trigger-happy as was the case in the past.

In light of the rapidly changing Soviet environment there are some things which our government might do to facilitate small business trade with the Soviet Union.

1. Presently there is very limited professional assistance available to small businesses which want to trade with the Soviets -- a handful of lawyers and private consultants as well as a small staff at the U.S. Commerce Department. The Small Business Administration could play a catalytic role in launching a small business equivalent of the U.S.-U.S.S.R. Trade and Economic Council aimed at smaller American and Soviet businesses including the new private businesses and cooperatives in the Soviet Union.

2. The Jackson-Vanik Amendment is a cold war anachronism and should be repealed. Most-favored-nation status should be granted to the Soviet Union and the rest of Eastern Europe. The Soviets should be given positive encouragement for the considerable progress they have made in the area of human rights.

3. The Pentagon's irrational technology transfer policies should be replaced by policies based on today's realities rather than yesterday's myths.

4. In general, the Congress should review the whole range of cold war trade restrictions -- many of which are no longer in the interest of our country or small businesses.

In summary, perestroika offers small American businesses three important benefits -- (1) new opportunities for trade with a country which has a healthy appetite for American-made goods and services; (2) a chance to recoup some of the high-tech business which was lost to the Japanese and the West Germans as a result of U.S. government export controls; and (3) a reduction in the risk of war between the two global superpowers.

There may be some unique opportunities for the leaders of small American businesses to increase their profits and contribute to global peace by assuming a stronger leadership role in East-West trade and joint ventures. Rather than resisting global interdependence, we should embrace it. As Megatrends author John Naisbitt has said, "If we get sufficiently interlaced economically, we will probably not bomb each other off the face of the planet."

It's not business as usual in Moscow, and it's no longer in our self-interest to continue pretending otherwise.

Thomas H. Naylor is Professor of Economics at Duke University and the author of The Gorbachev Strategy (Lexington Books, 1988).

Addendum

OUR DENIAL OF PERESTROIKA

In spite of mounting evidence that perestroika (economic and political restructuring) is here to stay, many Sovietologists cling to the notion that radical reform is impossible and that Mikhail S. Gorbachev is doomed to failure. Since Gorbachev has neither denounced Marxist-Leninist ideology nor embraced capitalism, skeptics claim that the Soviets will never change. Improved U.S.-Soviet political and trade relations are viewed as a myth. There is no room in the temple of doom for Gorbachev.

At the June 1987 Party Plenum, the Central Committee gave Gorbachev control of the Politburo and approved a list of new radical economic reforms, including self-financing of enterprises, decentralized decision making, and the election of factory managers by [redacted] employees. Yet for six months before the Plenum, Sovietologists warned that Gorbachev was facing increased opposition to perestroika and forecast his demise. But where is the evidence that Gorbachev is facing such insurmountable obstacles? Just before the Plenum a small plane landed in Red Square. Two days later Gorbachev fired the defense minister and the commander of air defenses – hardly suggesting that he was dealing from a position of weakness.

In October 1987, Moscow Party boss Boris N. Yeltsin was forced to resign after a speech before the Central Committee. Sovietologists said this was evidence of Gorbachev's growing political problems – particularly with No. 2 Communist Party official Yegor K. Ligachev. Nothing could be further from the truth. When a high-ranking official embarrasses a nation's leader, the official is likely to be fired, as was the case with Chinese Communist General Secretary Hu Yaobang in January 1987. China watchers warned this signaled a reversal in Chinese reforms. The reforms have continued unabated since then. Not unlike the Hu affair, the Yeltsin affair was much ado about nothing.

Until his recent demotion by Gorbachev, Ligachev was the darling of the American press. It was a though each new reform would be Gorbachev's last. If disillusioned Moscow bureaucrats such as Ligachev didn't topple Gorbachev, he would surely be ousted by political unrest in either Eastern Europe or among Soviet ethnic minorities.

What has actually happened during 1988? The new Polish government is negotiating with Solidarity leader Lech Walesa; aging Hungarian Socialist Workers' Party leader János Kádár was succeeded by a Gorbachev-like reformer, Karoly Grosz; and the Communist Party leaders of Armenia and Azerbaijan were replaced after months of ethnic tension. The Moscow summit proved to be a public relations bonanza for Gorbachev and the Party Conference a new high-water mark for perestroika. Then, as though this were not enough, he recently retired four conservative Politburo members, reorganized the Central Committee, and had himself named President.

The Soviet reforms are being driven by a combination of domestic and international forces which are independent of Gorbachev and predate his rise to power. They now have a life of their own and will survive with or without Gorbachev.

American cynics seem to confuse their own needs for instant gratification with those of the Soviets, failing to realize that since 1917 the Soviet people have been promised more consumer goods. There is no evidence to suggest that asking the Soviet people to wait a little longer is going to lead to Gorbachev's demise.

Our denial of perestroika reminds me of growing up in Jackson, Mississippi, during the 1950s. Nearly one hundred years after the war – the Civil War – few white Southerners acknowledged that the war was actually over and that blacks deserved to be treated as human beings rather than as slaves. It was not until the late 1960s and early 1970s that white Southerners began to abandon some of their stereotype views of blacks.

Is it any wonder that Americans find it equally difficult to believe that fundamental changes have taken place in the Soviet Union? For over 70 years, but particularly since the 1950s, we have been told repeatedly that, "You can't trust the Russians." Anticommunism has been the driving force of our foreign policy since World War II. We are so conditioned to always assume the worst about anything the Soviets do or say that it is virtually impossible to view them in any other way.

Unlike the South which lost the Civil War but continued to pretend otherwise for over one hundred years, the U.S. has actually won the ideological battle with Stalin-like communism. Ironically, while the Soviets know that we won, most American politicians seem to be oblivious to that fact. Otherwise, why should we continue spending $300 billion annually to protect ourselves form the Russians?

President Ronald Reagan's appearance in Red Square in front of Lenin's tomb with his arm around General Secretary Gorbachev may have signalled the beginning of the end of the cold war. The real message of perestroika is that traditional Marxist-Leninist ideology is dead in the water. There are no examples of successful Marxist-Leninist states anywhere in the world. It is no longer in the self-interest of either superpower to continue perpetrating the myths, half truths, and outright lies which have fueled the cold war since the late 1940s - a point which Mr. Gorbachev seems to understand. Hopefully it will not take us another hundred years to figure that out.

Thomas H. Naylor

Thomas H. Naylor is a writer who teaches at Duke University and is the author of The Gorbachev Strategy (Lexington Books).

TRADE AND INVESTMENT IN THE SOVIET UNION: PROSPECTS FOR AMERICAN SMALL BUSINESS

Testimony of

Eugene Theroux
Baker & McKenzie
Washington, D.C.
with
Arthur L. George
Baker & McKenzie
Washington, D.C.

before the

Committee on Small Business
U.S. House of Representatives
September 30, 1988

I appreciate the opportunity to present views on the legal aspects of our developing economic relations with the Soviet Union, particularly as regards small business.

My name is Eugene Theroux. I am a partner in the law firm of Baker & McKenzie in Washington, D.C. I am before this Committee speaking strictly as an individual, and not on behalf of my firm or any client. I am accompanied by my colleague, Arthur L. George, an attorney who speaks Russian and is involved with me in our Soviet practice.

It may interest the Committee that Baker & McKenzie, with more than 1100 lawyers in 27 countries on five continents, is the largest law firm in the world. More than half of our lawyers are nationals of countries other than the United States, more than half practice outside of the United States, and most of our offices are located in foreign jurisdictions.

Most of my nearly twenty years in private practice have been devoted to international civil litigation and international commercial transactions. Much of that time, more than sixteen years, has involved the legal aspects of trade and investment with the People's Republic of China. In all, I have made some 150 trips to China, and I have spent more than five years there in the aggregate. More recently, over the last three years, I have been involved on behalf of clients with the USSR.

I know I am not alone in speculating that the Soviet Union today could become as rewarding a trade and business partner as China has proved to be for so many American business firms. My testimony will draw on extensive experience with China, for there are many considerations and problems common to China and the USSR as far as doing business is concerned, and on my more recent involvement with the USSR. I hope to assist the Committee in evaluating the prospects for U.S. businesses, and small and medium-sized businesses in particular, in the USSR. In particular, I will address:

1. The opportunities available to small businesses to expand trade with the Soviet Union, with particular emphasis on

joint ventures that involve, either directly or indirectly, small businesses;

2. The legal and policy framework in the Soviet Union insofar as trade and investment with U.S. small business is concerned;

3. The legal constraints in the United States and the USSR which currently inhibit trade and investment;

4. The policies in both countries that need to be developed in order to assist small business; and

5. The lessons learned from doing business with the Soviet Union.

Two preliminary points should be made.

First, our emerging commercial relations with the USSR, stimulated as they are by General Secretary Gorbachev's policies of perestroika and glasnost, are as yet too new for us to be able to draw firm or final conclusions. Aside from leading American firms such as PepsiCo, Inc., which pioneered business with the Soviet Union and which I know continues to enjoy constructive and expanding commercial relationships there, only a comparative handful of American businesses have sent representatives to the USSR to explore possibilities seriously, fewer have negotiations under way, and fewer still have concluded joint venture agreements.

Interest is strong, nonetheless. In July, I chaired a two-day conference in New York, sponsored by the Practising Law Institute, on the subject "Legal and Practical Aspects of Doing Business with the Soviet Union." It drew representatives of 125 companies. Earlier, in April of this year, I was among some 500 business representatives who descended on Moscow for the 1988 annual meeting of the U.S.-USSR Trade and Economic Council.

Second, predictions at this early stage of the Gorbachev era, as with any prognostications founded on assumptions based on insubstantial data, may turn out to be quite wrong.

In this latter regard, I had a personal experience with China that proved instructive in the present context. In June, 1972, about three months after President Nixon's historic trip to China, I had the honor, as Special Counsel to the Joint Economic Committee of the Congress, to accompany to China the leaders of the House of Representatives, Majority Leader Hale Boggs and Minority Leader Gerald Ford. On our return, Mr. Boggs and Mr. Ford presented to the House a report entitled "Impressions of the

New China" (House Doc. No. 92-337, 92d Congress, 2d session). That report contains the statement that "[t]he exchange of goods, like the exchange of people, can be a bridge to better mutual understanding and improved political relations." While that has definitely proved to be the case in China, our trade with that country has evolved in ways we did not foresee. On that visit, we were told that in foreign economic relations there were "forbidden zones." China, we were advised, would never import foreign consumer products, would never permit foreign participation in exploration or development of China's natural resources, and would never seek foreign capital. In the years since 1972, when such policies appeared to be unchangeable verities, I have personally been involved with the Chinese in projects in all of these once "forbidden" areas.

Today the USSR beckons American business as did China in 1972. The Soviet Union offers now, as China offered then, a "new frontier" for trade and investment -- opportunities unique, uncertain, alluring, potentially large and profitable, at once the picture of straightforward simplicity and bewildering complexity. As with China then, some business observers are euphorically optimistic, others darkly pessimistic, about business with the USSR, and there are those with ideological or political axes to grind who seek to frustrate or burden or economic relations with obstructive policies, laws and regulations. For China, all but the dreamiest, most euphoric optimists were off the mark, the pessimists were wrong, and the obstructionists became irrelevant.

The point is that even optimistic forecasts did not anticipate the remarkable achievements that American firms, both large and small, have made with Chinese enterprises, as buyers, suppliers, joint venture partners and exchangers of technology and know-how. To be sure, there are differences between the China of 1972 and the Soviet Union of 1988. Most obviously, the USSR rivals the United States globally in the most sobering aspect: it is our most powerful potential adversary with whom state relations have proved difficult and even dangerous. A rational argument can be made that the USSR's self-acknowledged economic difficulties lessen the Soviet danger to the United States, and that we should not allow, much less encourage, U.S. firms to supply needed capital, goods and know-how to struggling Soviet enterprises. But that argument does not persuade me. U.S.-China economic relations since 1972 have proved a very important contributor to stability, understanding and peace, and I have little doubt and much hope that U.S.-USSR economic relations are poised to do the same.

Now, let me turn to the more specific subjects at hand.

1. Joint Ventures

In January, 1987, the Soviet Union promulgated a law permitting Soviet enterprises to enter into equity joint ventures with foreign firms. The Soviet newspaper Izvestia, on September 12, 1988, reported that there are now 94 joint ventures registered in the USSR, representing capital investment aggregating $500 million. By the end of 1988, the Ministry of Finance of the USSR anticipates 150 joint enterprises with a total investment exceeding $1 billion.

The joint enterprise law, and subsequent implementing regulations and decrees, has attracted considerable interest from abroad, including American firms. They perceive the joint venture law as a potentially important means of gaining access to the Soviet domestic market for their goods and services, and some also see the law as a means for establishing a Soviet manufacturing base for serving third-country markets.

Soviet enterprises have embraced the joint venture concept at least as readily as foreign firms. They recognize the potential of a joint venture, in the language of Article 3 of the law, to "satisfy more fully domestic requirements for certain types of manufactured products, raw materials and foodstuffs." They can also appreciate the importance of attracting foreign capital, advanced equipment and technologies, and management expertise, to invigorate the Soviet industrial, agricultural and service sectors, and to conserve foreign exchange through import substitution, all goals of the joint venture law.

Both sides in a joint venture should recognize early, however, that among the hurdles normally to be anticipated in bringing such a venture into being is one in particular that has proved enormously problematic in soft currency economies like the USSR: that is, the foreign party will normally seek profits in hard currency, while sales or services to the domestic market of course yield only soft currency proceeds. Foreign firms are encouraged by Article 32 of the joint venture law, which provides that foreign partners are "guaranteed that amounts due to them as their share in distributed profits of the joint venture are transferable abroad in foreign currency." But that guarantee is substantially qualified by Article 25 of the same law, which States that all foreign currency expenditures of the joint venture, "including the transfer of profits . . . shall be covered by proceeds from the sales of the joint venture's products on foreign markets." This limitation, reflecting a primary Soviet intention that joint ventures earn foreign exchange through exports, presents obvious problems for any foreign firm whose major goal is the USSR domestic market.

This "foreign exchange balance" dilemma still plagues joint ventures in China nearly a decade after the PRC enacted its joint venture law. It reflects the reality that in many instances foreign firms and their prospective Chinese partners, each believing a joint venture will meet their objectives, in fact, have quite different goals, and are talking past each other. This problem has produced the colorful adage that a joint venture in which the parties' objectives diverge is one in which "the partners are sleeping in the same bed, but dreaming different dreams."

Any firm contemplating a joint venture in the Soviet Union, and a small firm in particular, should be aware of the following facts:

1. A joint venture between two U.S. parties, operating in the U.S., where the parties speak a common language, deal in familiar traditions and operate in a commonly understood legal framework, can be a difficult proposition. A joint venture between a U.S. and a Canadian party -- different traditions and law -- will be more difficult. A U.S.-Mexican joint venture -- more radical differences of culture, tradition, law and language, and greater distance -- will be still more difficult. So obviously, a joint enterprise between a U.S. and a Soviet joint venture presents formidable difficulties.

2. Joint ventures in the USSR need not be out of reach of small U.S. firms. Soviet enterprises themselves often express a desire to work with small and medium-sized U.S. firms. Nevertheless, the opportunities for these firms will be somewhat less than for large firms. The primary reason is cost. Even large American corporations are themselves daunted by the costs associated with pursuing a possible venture in the USSR. The cost of executive time spent in the USSR, and in fashioning and reviewing proposals at home are alone substantial, not to mention the cost of travel and communication between the U.S. and the Soviet Union, which can be considerable. And this does not include costs associated with operating a venture, usually with some home-office managerial and technical personnel, posted in the Soviet Union over a period of time. A second factor is that Soviets consider the resources and staying power of potential joint venture partners, and smaller firms may face a higher burden in demonstrating to the Soviets that they are suitable long term partners.

3. Perhaps the best opportunities for American small business in the early stages of the newly warming U.S.-USSR commercial relationship will be as suppliers of goods and services, or subcontractors, to joint ventures in which larger U.S. (or other foreign) corporations are in a partnership with a Soviet enterprise.

4. Another potential opportunity for smaller businesses lies in the rapid rise of privately owned cooperatives in the USSR, stimulated by a new law on cooperatives which went into effect in July of this year. These businesses may be granted foreign trade rights, including the right to enter into joint ventures with Western firms. They have already organized into associations of cooperatives at local and regional levels, and soon will have a national organization. As the cooperative movement develops, joint venture opportunities and other trade opportunities may develop for small and medium-sized U.S. businesses.

5. The most promising areas for U.S.-Soviet joint ventures, it seems to me, will be in areas related to:

tourism, such as hotels, transportation, food service and telecommunications;

manufacturing, where U.S. equipment and know-how can produce new or improved and competitively priced products for the international market;

agriculture, particularly insofar as projects may contribute to more efficient production, delivery, processing and marketing of livestock, poultry, vegetables fruits and grains.

2. The Legal and Policy Framework in the USSR

The Soviet legal and policy framework is in a transition stage. Until recently, the USSR has not had a legal and policy framework to nurture is own enterprises, much less one hospitable to foreign firms. The inefficiencies and bureaucracies which appear to have stymied centrally planned economies throughout the world are, led to the policies of glasnost and perestroika. Perestroika is designed to make the Soviet economy function principally on the basis of market forces. This necessitates a vast restructuring of the production, supply, distribution and pricing systems, which is only partly underway. Glasnost, the openness intended to foster the uninhibited discussion of problems and exchange of information, is an complementary concept essential to the success of perestroika.

These new policies, if continued, will make the Soviet Union more like us in important respects. A stronger basis for mutual understanding and mutual interest will evolve, which will place U.S.-Soviet relations on a stable basis that is more secure than the detente of the 1970s.

While the potential foreign investor is lured to the USSR with an undeniably attractive legal framework, and a positive Soviet national leadership rhetoric to match, it is too soon to tell if such laws and policies, and the enterprises, innovations and efficiencies they are intended to create, can escape suffocation by the bureaucratic inertia which has accumulated over the years. A joke current in Moscow tells of the bureaucrat who complains that perestroika has woefully burdened his department, with staff reductions and new expectations that it do the work of ten men. "Thankfully it may not be impossible," he says, "since we are still left with a staff of fifteen." This problem was candidly acknowledged recently by a Soviet official of the Soviet-French-Italian joint venture "Interkvadro" who said, according to Izvestia, that "the system of administration through commands which has ruled for many decades in our economy has made people unaccustomed to displaying initiative, independence, and enterprise -- all the qualities which you simply cannot do without in a new undertaking and which are now lacking most of all."

The Soviets are sensitive to these problems as they affect foreign firms seeking to do business in the USSR. Recently, for example, the Soviet authorities (the USSR Council of Ministers and State Foreign Economic Commission) have encouraged the formation of a "Joint Enterprise Association," composed of representatives of joint ventures, to become the "defender of the interests of joint enterprises."

3. The Legal and Policy Framework in the United States

No discussion of U.S. trade and investment in the USSR can be complete without reference to the great unmet expectations of the 1970s period of detente, and the never-ratified U.S.-Soviet Trade Agreement of 1972.

The high hopes of detente for increased trade, and the 1972 trade agreement in particular, were in this observer's view dashed less by Soviet misbehavior than by anti-Soviet forces here who found a Congressional majority willing to give expression to their causes in the Jackson-Vanik amendment. This is particularly evident when one takes as a guide the lack of linkage that the United States imposes between human rights and trade with most other countries. I want to make clear at the outset that I do fail to see why the Soviet Union, in its own interest if not as a response to external pressures, does not facilitate the prompt departure of any national who has applied to leave the USSR. Be that as it may, the policy question we face is to what extent the U.S. Government may be justified or effective in pressuring the Soviets to facilitate emigration, and whether the particular linkage of the Jackson-Vanik amendment is the appropriate means. I believe that this particular linkage is not only ineffective, but that it ill serves U.S. businesses and is counterproductive in the overall U.S.-Soviet relationship.

My dispute with the Jackson-Vanik amendment stems in part from the example of China. U.S.-China relations were frozen for some twenty years, with an absolute embargo on trade, between the Korean War and Nixon's 1972 China visit, largely because Congress perceived itself impotent to deal with the power of the "China Lobby." Who knows what good might have come to the United States out of earlier common-sense relations with the People's Republic of China? Vietnam, the most wracking American debacle of this century, might have been avoided or brought to an earlier conclusion.

Now, Congress is equally captive -- let us face facts -- to a lobby whose thirst for Soviet political concessions is probably unquenchable. As long as Congress finds itself incapable of responding to new and positive Soviet realities, we will be as unable to respond to opportunities to advance our national interest with the Soviet Union as we were with the PRC when our misguided policy was to "contain China."

It is said by some that most-favored-nation tariff treatment accorded to imports from the USSR, and the availability of export credits and OPIC insurance to U.S. exporters interested in the USSR, would not make a significant difference in the volume of U.S.-Soviet trade. At least initially, maybe so, but the economic reforms in the Soviet Union promise an increase in exportable Soviet goods. To the extent that the Soviets are denied U.S. dollars by this restriction on exports to the United States, Soviets lack the currency needed to purchase goods from U.S. businesses, thus hurting these businesses' ability to export to the Soviet Union. Further, ironically, the Jackson-Vanik amendment penalizes exports to the United States by joint ventures involving U.S. participants.

It is pointed out by others that the failure of the US. to ratify the 1972 trade agreement with the Soviet Union absolves the USSR from obligations contained in that agreement to make substantial payments to the U.S. treasury for amounts past due under the Lend-Lease program. This is so, but the particular clauses in the trade agreement, and their evisceration by Jackson-Vanik, are less important than the fact that economic relations with the USSR should not be subject to such linkages.

The Soviets do little to advance their interests in the United States when they imply that a condition precedent to improved relations might be more humane U.S. policies toward our minorities, our unemployed and our homeless. We rightly regard this as unacceptable interference in our domestic affairs by meddlers with ulterior motives, even though we acknowledge such shortcomings in our society. Soviet irritation with similar criticisms from elements in this country is likewise understandable. In our trade and investment relations with the USSR, Congress should resist the crusades of single-issue movements, however well intentioned.

Should the U.S. Government regulate trade and investment by U.S. parties in the Soviet Union? Of course. Our controls on strategic exports, for example, are essential. But we should no more tie trade benefits such as tariff treatment and export credits to Soviet domestic policies than we would deny such benefits to other countries -- there are many with whom we trade -- whose domestic policies offend us. To the extent that emigration is a concern of the United States, it is a political problem that should be dealt with on the political level. Emigration has risen and fallen with the ups and downs of the U.S.-Soviet political relationship and has been affected only marginally, if at all, by the Jackson-Vanik amendment. I very much doubt that increased emigration will be facilitated by demands made belligerently and publicly. The better approach is to leave commercial relationships alone and obtain progress through quiet diplomacy and subtle political pressure.

4. Appropriate Policies in the USSR and the United States

To further encourage all business relationships with the United States, the Soviets need to continue to implement the reforms of perestroika and glasnost. As the Soviet economy and begins to operate on a market-like basis, trade opportunities for small businesses similar to those in other countries will appear. As noted at the outset, U.S. policy should be to encourage these reforms, and to respond to them. A good start would be to eliminate the Jackson-Vanik amendment.

A second Soviet initiative that needs to be fostered is the development of cooperatives. The Soviet press reports that, as of July 1 of this year, over 32,500 cooperatives had been registered employing nearly a half million people. The Soviets expect that cooperatives and individual enterprises will eventually account for 25%-30% of the Soviet economy. This development should not be ignored by U.S. businesses and U.S. and Soviet policymakers. Small businesses in both countries will have much in common. The two governments should find ways to facilitate communication and the exchange of information between their business entities. This could be done in the context of the U.S.-U.S.S.R. Joint Commercial Commission. One concrete aspect of this might be to facilitate the development of sector-specific trade exhibitions for small and medium-sized businesses in the Soviet Union, because small businesses often have greater difficulty in identifying and meeting with potential customers than large firms.

A third measure of long-term importance is the exchange of human resources. Currently, there are about 30,000 foreign exchange students from the People's Republic of China in the United States. Most of them study in business, economics and technical areas, and they return to China to work in the development of China's economy. This exchange has been an important aspect of the improved trade relationship between the United States and China. Although the nature of the U.S.-Soviet strategic relationship imposes some limitations on a similar program with the Soviet Union, a broader educational exchange, specifically including an graduate schools of business and law, would be helpful in improving the U.S.-trading relationship at all levels.

5. Lessons Learned from Doing Business with the USSR

Broadly speaking, I have learned the following from doing business with the Soviets over the last couple of years:

1. They are serious, in most instances more serious than their American negotiating partners, in pursuing joint venture agreements. This means, in some instances, that they are eager for joint ventures in projects that do not lend themselves

to that form of doing business, and which may be more suitable to buy-sell or license agreements.

2. They are not sufficiently understanding, owing no doubt to the kind of society in which they live, of the fact that American firms do not give serious consideration to a possible joint venture unless it offers a genuine prospect of profit within a reasonable time. An unfamiliarity with establishing true costs of production, and pricing accordingly, exacerbates this problem.

3. They have not fully resolved, in their minds or in policy, how it can be that the fruits of a joint venture -- its products or services - can both benefit the USSR domestic market and earn foreign exchange; if foreign capital, equipment, know-how, management and technical expertise are to help improve the standard of living in the Soviet Union, the joint venture's products should reach the Soviet market, but since the proceeds from sales on the Soviet market would be in nonconvertible rubles in the great majority of cases, most joint ventures will be forced to look to the international market.

4. At least at the outset, they often lack an appreciation of the time it will take, in most instances, for a joint venture to proceed from the proposal stage through a

feasibility study toward a contract to start-up and finally to operation.

5. Notwithstanding the foregoing points, which to some degree are present in all international business in any event, the U.S. business representative finds in the Soviet Union today a potential business partner who is willing to go more than half way to achieve a mutually rewarding result. That the Soviet side offers enthusiasm, a surprising ability to conduct negotiations in the English language, willingness to work toward a shared goal, and an evolving legal and policy framework hospitable to business cooperation, should be enough to attract many American firms to the negotiating table, at least.

- END -

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November 21, 1988

Honorable John J. LaFalce
Chairman
Committee on Small Business
2361 Rayburn Building
Washington, D.C. 20515

Re: Committee Hearings on "Prospects for Increased Trade with the Soviet Union by American Small Business"

Dear Chairman LaFalce:

Enclosed are the supplemental comments of Eugene Theroux and myself for inclusion in the record of the Committee's hearings on opportunities in the Soviet Union for U.S. small businesses. Please let us know if the Committee has any questions regarding these comments.

Sincerely,

Arthur L. George

Arthur L. George

Enclosures

cc: Ms. Patricia Lord
Chief Clerk
House Committee on Small Business
Ms. Kathryn Wittneben
Economist
House Committee on Small Business
Eugene Theroux, Esq.

SUPPLEMENTAL VIEWS OF EUGENE THEROUX AND ARTHUR GRORGE OF BAKER & McKENZIE REGARDING BUSINESS OPPORTUNITITES IN THE SOVIET UNION FOR U.S. SMALL BUSINESSES

At this Committee's hearings on September 30, 1988, Arthur George indicated in his testimony that we would be in the Soviet Union in the following weeks, during which time we would be holding meetings with, among other persons, leaders of small state and private enterprises in the Soviet Union to discuss the latest developments concerning small businesses in that country. The Committee expressed interest in obtaining our supplemental comments following this trip. This letter sets forth our additional views based on these discussions and on events in the Soviet Union since the September 30 hearing. We focus on the status of small and medium-sized business enterprises in the Soviet Union and the implications that recent developments in the Soviet Union have on opportunities for small businesses in the United States.

The most fundamental development since the September 30 hearing has been Secretary Gorbachev's further consolidation of his own power in early October, through the retirements and reappointments of Soviet officials. This indicates that Gorbachev is securely in power and that his reforms will continue for the foreseeable future. This is a stabilizing development that should give businesses contemplating entry into the Soviet market confidence that any efforts and investments they make in this direction will not be brought to nought by a sudden reversal of policies or change in leadership.

Small businesses in the Soviet Union consist of smaller state enterprises and privately run individual and cooperative enterprises. As the program of perestroika sets state enterprises on a footing of financial self accountability, and as the policies disfavoring private enterprises hiring employees are relaxed and these enterprises grow in size, the difference, in substance, between private and state enterprises will tend to narrow. In fact, some former state enterprises have been transformed into cooperatives. For instance, a Moscow factory producing low voltage electrical equipment that employs approximately 1500 workers was recently transformed into a cooperative enterprise. TASS recently reported that, in the first three months of this factory's operation as a cooperative, productivity increased by 15 percent.

The private enterprises are rapidly growing in number. TASS recently reported that the number of private cooperatives now exceeds 35,000 and that cooperatives now employ over 700,000 people. In general, these enterprises are prosperous. Many have accumulated surprising amounts of rubles, but there is little on which to spend the money on the Soviet market. Purchasing from abroad is often the desired alternative. These enterprises may obtain permission to engage in foreign trade from local authorities, establish a foreign currency account on their books and open bank accounts in foreign currency.

Private enterprises are interested both in direct purchases and in joint venture projects with foreign companies. With respect to joint ventures, it should be noted that Soviet leaders recently announced that further modifications to the joint venture law are planned for early 1989, in order to make joint ventures more attractive to foreign investors. In particular, foreign enterprises will be allowed to obtain a controlling interest in joint ventures. Further concessions to foreign investors may soon be available to enterprises located in the northeast of the USSR, because the Soviet Government has indicated that it wants emphasize development of that region, in part through increased foreign investment. Finally, the Soviets are considering opening up special economic zones, particularly near ports, similar to those which now exist in China. More generous tax and customs privileges would likely be available to joint ventures locating in such zones. As a result of these developments, joint ventures in the Soviet Union may become a more attractive option for small businesses than they have so far.

As of now, however, both American and Soviet small business enterprises lack the capital to enter into large joint venture investments involving production, although the increased availability of credit may gradually improve this situation on the Soviet side. For the time being, any joint venture projects between U.S. and Soviet small businesses will be limited largely to service-oriented projects, particularly food service establishments. In order to obtain hard currency, it will be helpful to locate in or around establishments that serve foreigners, such as airports, hotels and tourist attractions.

With respect to direct purchases, both private and state small and medium-sized enterprises are interested in purchasing a wide variety of goods from the West. For instance, we recently spoke with resturant owners who wish to purchase modern Western kitchen equipment. A cosmetics factory we visited wishes to purchase packaging materials, labels and cosmetic containers and pumps. A fur enterprise we know of wishes to obtain modern equipment for treating furs and producing fur articles for export. The Moscow low voltage equipment factory mentioned above has approximately 2,000 suppliers and customers. As enterprises such as these become more efficient and export or otherwise obtain hard currency, business opportunities will increase.

Most such enterprises, however, still lack hard currency to pay for such purchases. Some of these enterprises produce products that are saleable in the West that could be traded for the imported goods, but many do not. The increased availability of credit, including hard currency credits, may alleviate in the short term the hard currency deficit for enterprises that have the capability to generate hard currency to repay hard currency loans. With respect to private enterprises, cooperative banks have begun to spring up, which will serve principally as savings and lending institutions to private enterprises. With respect to state enterprises, the recently announced European loans to the Soviet Union may facilitate increased purchases from abroad. Although many of these loans are "tied" in the sense that the funds must be used for purchases from the lending European country, these loans can still benefit U.S. businesses because the loans should free up other, untied hard currency funds for potential purchases from the United States. In summary, we see a gradually improving hard currency situation that will facilitate increased direct purchases from U.S. small and medium-sized businesses.

Given that trade opportunitites are increasing, the next question becomes how potential U.S. and Soviet business partners can contact each other. Soviet enterprises may now deal directly in foreign trade, without having to go through intermediary foreign trade organizations. The identity of these potential customers, however, is not easily discoverable. A U.S. company could begin by contacting the USSR Trade Representation in Washington or Amtorg Trading Corporation in New York in order to learn which ministries to contact in the Soviet Union, and these ministries can suggest enterprises who may be potential customers. Another effective way has been through the efforts of private enterprises, including trading companies who are in the business of finding buyers and sellers in the Soviet Union, as well as other private consultants, banks and law firms.

A newer phenomenon is the establishment of private and state consulting enterprises in the Soviet Union who specialize in bringing buyers and sellers, or joint venture partners, together and providing other advisory services. The difficulty is that these enterprises charge handsomely for their services, in hard currency of course, and their effectiveness has yet to be proven. In most cases, it is probably better to exhaust the more traditional means of locating customers described above before trying this route.

Another recent development that may eventually lead to easier market access for small U.S. firms is the development of cooperative associations. On our most recent trip, we met with the chairman of the Leningrad association of cooperatives and discussed cooperative associations with other business and government officials. These associations are formed to represent the common interests of cooperatives vis-a-vis governmental authorities at all levels. They are still in their infancy, however, and are not yet well organized or effective. Particularly notable is the reluctance of cooperative owners to share information about their operations, finances or business plans. As a result, the associations lack a useful body of information about their membership. This situation will probably improve over time. As it does, the associations could probably play a role in coordinating foreign trade activities of their member enterprises, including the collection and distribution of information useful in bringing buyers and sellers together.

In conclusion, developments since the September 30 hearing give increased cause for optimism about the potential for better business relations with the Soviet Union. The development of increased business ties is best achieved through private enterprises. Beyond the modest steps for U.S. Governmental action recommended in our initial testimony, the best thing that the U.S. Government can do to foster these business relationships is (1) to improve the overall political climate with the Soviet Union, inter alia, by supporting the reforms, and (2) not to interfere in business relationships. With respect to the latter, the U.S. Government should resist the temptation to apply economic sanctions or deny trade pvivileges in response to Soviet political behavior. This should be done only if the Soviet action is of particular significance and America and its allies are able to respond consistently. Otherwise, we are simply hurting ourselves economically and worsening relations with our allies, without achieving the intended political goal.

We thank the Committee for the opportunity to provide these additional views. If members of the Committee or its staff have any further questions on these matters, we would be pleased to address them.

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Washington, D.C.
September 30, 1988

REPORT
TO THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS

ON

DEVELOPMENTS IN SOVIET-AMERICAN TRADE

I am here today to report to you about recent developments in matters of Soviet trade. I make my report as a practicing attorney in the field of international business transactions, and as a principal in a Los Angeles-based international trading company, Pacific Intertrade Corporation. I am also a member of the International Trade Policy Committee of the California State World Trade Commission.

My alotted time is quite short, and therefore, my comments will be directly to the point: there are major changes taking place in the Soviet Union today which focus on economic reform; as a result, there is unprecedented potential for trade opportunities with the Soviets as well as improvement in US-Soviet relations. I stress the word "potential", for there are unquestionably significant impediments to establishing normal trade relations with the Soviets. However, to ignore the challenge presented would be a serious error, both economically and politically.

The Soviet Union is undergoing a revolution, and the consequences to the world are likely to be profound. The Soviet Union is geographically the largest country in the world, spanning eleven time zones. It has the third largest population, some 285 million people. For over 70 years, since the October revolution in 1917, it has labored under a social, economic and political system we know as socialism. Like democracy and free enterprise in the U.S., socialism in the Soviet Union has been an experiment. But measured in terms of most economic criteria, our system has been an overwhelming success while Soviet socialism has failed.

Under what appears to be the enlightened leadership of Party Secretary Mikhail Gorbachev, the Soviets have initiated a bold attempt to abandon their self-imposed economic isolationism, to break free from the retarding consequences of socialism, and to enter the modern economic world. In short, the USSR is a country in crisis, and it seeks to address its crisis with sweeping reforms. Economically, those reforms invite Western businesses to tap a vast new market in return for imparting technology and know-how② The possibilities are inviting; the problems and pitfalls clearly evident and challenging.

The rapid pace at which the reforms are being instituted confirms the urgency of the need for change. With astonishing candor, Gorbachev first focussed the attention of his people and the world on the shortcomings of socialism. Then, to address these shortcomings, he undertook a series of widespread initiatives directed at salvaging and modernizing the Soviet system. He has labelled these reforms "perestroika", or "restructuring." It is a restructuring of almost all aspects of society.

Socially, he has fostered a concept of "glasnost", or an "openness" of expression; politically he has prescribed a path of "democratization", the involvement of a broader constituency in the affairs of government. There is no question, however, that the economic reforms of perestroika have been Gorbachev's principal preoccupation; and the flagship of these reforms has been the new program of Soviet joint ventures.

On January 13 of 1987, new Soviet laws were enacted which for the first time authorize the formation of joint venture businesses, on Soviet soil, between Soviet enterprises and Western capitalistic companies. The theory is simple: a Soviet enterprise contributes land, buildings, utilities, natural resources and labor; the Western company contributes technology, management, marketing and other free-enterprise expertise. The Soviet objectives are two: (1) to modernize at an accelerated pace; and (2) to generate hard currency, both for priority domestic use and to stimulate the Soviet entry into the world economy.

The American response to perestroika should depend upon the answers to two fundamental questions. First, is the Soviet Union sincere and credible in its efforts to enter the world economy? And second, most germane to our deliberations here today, what opportunities and benefits will flow to U.S. businesses from perestroika?

As regards sincerety and credibility, there are positive and convincing signs. To begin with, the Soviets' critical need for perestroika is indisputable. The planning and strategy have been intricate and comprehensive, suggesting the level of desparation. There have been major concessions in socialist philosophy, and unthinkable candor and humility. Much of the dogma which the Soviets have developed, defended and exported for over 70 years has been shed in less than two years in an effort to curb the country's economic decline. There are clear examples of this process. They fall into at least three basic categories: economic actions, political actions and social actions.

Economically,

(1) the Soviets are aggressively seeking entry into GATT and the World Bank, as well as most-favored-nation status with the U.S.;

(2) they are exploring a variety of solutions to the ruble convertibility problem; and, despite Western skepticism, they are optimistic that convertibility will be achieved in the short term;

(3) internally, ministries are being dismantled, reorganized and reoriented, to implement the novel outward approach to dealing with capitalistic nations. Many lower level enterprises are now authorized to deal directly with the West. Of course, the best example of this is the joint venture program.

Politically, the changes are impressing even the most ardent cynics. For example,

(1) Gorbachev's own book, Perestroika , published for worldwide consumption, which is a study in national humility and self-effacement;

(2) surprising Soviet restraint in the Persian Gulf, in the face of our substantial U.S. naval presence there;

(3) the numerous summit meetings and nuclear disarmament talks, where the Soviets have taken the initiative on many occasions; and, seemingly, they have rushed to start dismantling warheads to prove their commitment to arms reduction;

(4) punctual withdrawal from Afghanistan; and

(5) Gorbachev's recent offer to withdraw forces from the Soviet naval base in Vietnam if the U.S. would do the same in the Phillipines.

Within the Soviet Union, the change in attitude is equally dramatic:

(1) the sins of Stalin are being exposed and condemned, and the philosophy of Lenin is being reviewed and clarified, consistent with present goals;

(2) Soviet textbooks are being rewritten to reflect history from a more objective perspective;

(3) publications such as Pravda and Izvestia are printing opinions of citizens and journalists alike which are critical of government policies;

(4) there is now talk of a two-party political system;and

(5) political demonstrations within Moscow as well as the Republics are being tolerated;

The list of changes and events goes on and on, as indicated in our newspaper reports every day, all suggesting that the Soviet government is truly commited to accomplishing perestroika.

But even if the Soviets are becoming better world citizens, what about the second question presented: what does all of this mean to U.S. business?

The opportunity presented for US companies is to reach a heretofore impenetrable market, of vast proportions, possibly to the exclusion of competition, at least in the short term. The concept is appealing and logical enough, but the execution is most difficult.

The first major deterrent to most Western businesses is the basic problem of accomplishing anything in the Soviet Union where free enterprise attitudes, services and experience are sorely lacking. The process is laborious, often frustrating and, as a result, expensive. The second and much-discussed deterrent is the problem of reaping benefits in "hard" or convertible currency. The American executive is generally willing to assume the risk of profitability; he will weigh all factors and trust his judgment. He has entered markets throughout the world, under all types of circumstances, and he has succeeded. But, if after meeting all of the challenges of doing business in the USSR, if after the joint venture actually manages to make a profit, he must then still face the problem of not being able to repatriate his earnings in hard currency, he may decide that his investment dollars are better spent elsewhere.

While some companies are turning back in the face of this and other problems embedded in the joint venture laws, scores are moving ahead, many quickly, to penetrate the new Soviet market. Today, the interest level is quite high, due in no small part to the impressive public relations effort which the Soviets have staged. They have put out the welcome mat to U.S. businesses in particular. In some cases, they have sent delegations here, not just to target particular industries, but even specific companies producing products which are in greatest demand in the floundering Soviet economy.

There are presently many companies at various stages of Soviet trade negotiations. I, myself, currently represent companies in such diverse fields as breakfast cereals, toys, communications, education and children's books, real estate development, oil drilling equipment, gymnasium equipment, and clothing and asceptic food processing equipment. These clients range in size from the Fortune 500 to start-ups. The common denominator is their appreciation of the rare opportunity to enter the immense new Soviet marketplace.

There are natural advantages which larger companies have over small businesses, the most obvious being the resources to pursue opportunities in a difficult region like the Soviet Union. But the unique features of this marketplace are also proving particularly beneficial to small businesses. For example, since the Soviets have a controlled, centralized economy, it is not only possible but probable that certain monopolies will exist for some time until a mixed economy can develop. Monopolies may exist either by industry, by product or by region, or all of the foregoing. As a result, the Soviet focus in many cases is on a particular product or technology of a US company, not its resources to manufacture or market it. The Soviets themselves have the basic resources and can control the internal market; thus, if the technology is one which they want badly enough, many of the impediments to developing the means of production and penetrating the marketplace will be eliminated, including any shortage of capital. The result is a levelling effect as between large and small businesses. Of course, the joint venture vehicle itself provides an easy solution to this problem, since the percentage interest of the smaller U.S. partner can merely be reduced to reflect its more modest capital participation.

It is quite conceivable, therefore, that the same pattern which we see in the U.S., where small businesses far exceed large businesses in their share of innovation and national production output, will be evidenced in the development of Soviet-American trade in the era of perestroika. Certainly, the cost of initial negotiations with the Soviets may be a matter of concern for the small businessman, for at this stage he is competing with big business for Soviet attention; but thereafter, he may find his disadvantage to lessen. Obviously, the larger corporation will also be better able to endure financially if the purpose is to manufacture a product which requires a large capital investment or a protracted period of time to bring to market. But many products and services are not so capital-intensive, and it is the know-how which is most attractive to the Soviets.

Many of us are addressing the ruble convertibility problem, and we are finding solutions which lessen, if not neutralize, the concern. Such solutions range from new forms of countertrade to Soviet State Bank guarantees to creative financing arrangements with Western banks. The Soviet answer to the problem is to require the joint venture to export product to generate hard currency abroad which will be used to fund the distributions to the Western partner. This is good theory but in many cases it is unrealistic, at least until the joint venture is well-established and can deal with its domestic marketing requirements.

The export issue suggests one of the most important observations to be made for the small business considering entry into the Soviet market by means of a joint venture. The Soviets have carefully designed the joint venture model and are attempting to force every product or service to fit within the prescribed structure. Yet, all products and services are unique, and not all are readily susceptible to the joint venture approach. In addition, the Soviets generally lack the practical experience and creativity of a free market, and arguably do not fully understand themselves how their joint ventures will work. Thus, despite the fact that the Soviets appear intractible in their determination, their need to modernize and to make perestoika work is so compelling that flexibility will unquestionably be necessary. Therefore, a U.S. business should not accept the joint venture requirements at face value without carefully understanding their ramifications, and it should insist upon modification where necessary.

There may be some understandable reluctance to trade with the Soviets for political reasons, or because joint ventures may appear to result in the export of jobs rather than products or services. Yet, I submit that these arguments are not persuasive in light of the very real progress we are witnessing in the Soviets' effort to become better world citizens, and considering the potential for ancillary trade benefits which will flow from the joint venture activity.

The conclusion to be drawn from all this is that something very important is happening in the Soviet Union and it may translate into unprecedented trade opportunities for alert and visionary U.S. companies. It is my strong belief and recommendation that the Congress should monitor trade events in the Soviet Union carefully and develop a policy to support U.S. businesses, especially small businesses, wishing to explore the Soviet marketplace. American businesses are not alone in observing the developments; we are in fact reacting less aggressively than others such as the Germans and Japanese. Yet, there is a special reason for the Soviets to deal with Americans, and for us to deal with them. As the two most powerful nations on earth, locked in a perpetual ideological struggle, the Soviet Union and the United States have a responsibility to the rest of the world to explore every opportunity to substitute conciliation for confrontation. Communication is essential to the process. By beginning to dismantle our trade barriers, we may begin to develop a new, constructive relationship and with it a renewed hope for a lasting peace.

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